Watkins-Johnson

Annual Report

EXCELLENCE IN ELECTRONICS

CORPORATE PROFILE

Watkins-Johnson Company (NYSE:WJ) is a high-technology corporation specializing in semiconductor-manufacturing equipment and advanced radio-frequency products for the wireless-infrastructure market.

Semiconductor Equipment

The company's Semiconductor Equipment Group is recognized by its customers and industry experts as a worldwide technical leader in atmospheric-pressure chemical-vapor-deposition (CVD) systems used to manufacture semiconductors. Watkins-Johnson's products apply insulating, or dielectric, layers of silicon dioxide (glass) onto silicon substrates used in making integrated-circuit chips.

The WJ-999 (6-inch) and the WJ-1000 (8-inch) CVD systems maintain a large market share of the premetal-dielectric (PMD) deposition step in the manufacture of microprocessor, logic and computer-memory chips. In 1995, the company introduced the WJ-2000 cluster platform, which uses high-density plasma CVD technology. This equipment is designed to deposit follow-on dielectric layers in multilevel devices, a process known as intermetal-dielectric (IMD) deposition. WJ-2000 systems have been installed in Asia, where they are being used successfully in IMD and shallow-trench isolation (STI) processes.

Wireless Products

Watkins-Johnson's wireless-communications business units manufacture solid-state devices, components, subassemblies and equipment for the telecommunications industry. The foundation of Watkins-Johnson's wireless-communications strength is the company's gallium-arsenide (GaAs) technology. Highly reliable, proprietary chip designs perform signal-processing functions in subassemblies and systems for PCS, cellular and personal phone equipment.

High-dynamic-range mixers are sold in high volume for cellular-telephone base-station applications, while related subsystems and equipment perform signal-conversion and base-station functions in wireless-infrastructure systems worldwide. WJ's receiving and signal-analysis equipment is specified by government agencies for signals-intelligence mission requirements.

Facilities

The company operates at six locations. Semiconductor-manufacturing equipment is produced in Scotts Valley and San Jose, California. The Semiconductor Equipment Group also operates an Asia headquarters and technology center in Kawasaki, Japan. Microwave components and wireless subassemblies are manufactured at the corporate headquarters plant in Palo Alto, California, and gallium-arsenide integrated circuits and thin-film devices are produced at a newly acquired fabrication facility in Milpitas, California. Cellular base-station equipment and communications receivers are designed and built in Gaithersburg, Maryland.

This report, other than the historical financial information, consists of forward-looking statements that involve risks and uncertainties, including quarterly fluctuations in results, the timely availability of new products, the impact of competitive products and pricing, and the other risks detailed from time to time in the company's SEC reports, including the report on Form 10-K for the year ended December 31, 1997. Actual results may vary materially.

FINANCIAL SUMMARY

Sales for 1997 were $291,271,000, a decrease of 17 percent from the 1996 total of $349,119,000. The company's net income in 1997 amounted to $32,925,000, or $3.99 per diluted share. Net income was comprised of a net loss from continuing operations of $3,962,000, or $0.48 per share, and a gain related to discontinued operations of $36,887,000, or $4.47 per share. Comparable results in 1996 showed a net loss from continuing operations of $1,321,000, or $0.16 diluted loss per share.

Shareowners' equity on December 31, 1997 was $220,392,000, compared to $194,711,000 one year earlier. Shareowners' equity per share at 1996 year-end was $26.68, compared to $23.38 in 1996. The company's firm order backlog on December 31, 1997 stood at $98,168,000, down 35 percent from the restated 1996 year-end backlog for continuing operations totaling $152,108,000.

Three-Year Summary of Continuing Operations

(Dollars in thousands, except per-share amounts)	**1997**	1996	1995
Sales	**$ 291,271**	$ 349,119	$ 284,335
Net income (loss)	**(3,962)**	(1,321)	21,854
Basic net income (loss) per share	**(0.48)**	(0.16)	2.75
Diluted net income (loss) per share	**(0.48)**	(0.16)	2.49

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Watkins-Johnson at 40

Watkins-Johnson Company was founded in December 1957 by Dr. Dean A. Watkins, professor of electrical engineering at Stanford University, and Dr. H. Richard Johnson, head of the Microwave Tube Department at the Hughes R&D Laboratories in Culver City, California.

The company quickly established a reputation for excellence in products ranging from microwave devices and subsystems for defense electronics and space communications to full signal-collection and analysis systems for worldwide intelligence missions.

By the early 1980s, WJ had developed a continuous-process chemical-vapor-deposition (CVD) reactor which offered deposition rates far faster than other techniques available at the time. That CVD breakthrough formed the basis of WJ's success as a semiconductor capital-equipment manufacturer.

With the decline of aerospace and defense in the 1990s, the company applied its radio-frequency signal-processing skills to applications in the rapidly expanding wireless-communications industry. Today, Watkins-Johnson's business is entirely commercial, with about 60 percent of revenue coming from semiconductor equipment and 40 percent coming from wireless-infrastructure products.

TO OUR SHAREOWNERS

Sales from the company's continuing operations in 1997, although lower than 1996, met our plans.

Operating profit from continuing operations also met expectations, prior to the write-offs associated with the acquisition of Samsung Microwave Semiconductor and the financial difficulties of a few of our Asian semiconductor-equipment customers at the end of the year. Continuing business sales were $291,271,000 with an operating loss of $14,282,000 after the $22,000,000 expense associated with the write-offs outlined above.

Early in the year we announced our intention to divest the Tactical Subsystems and Microwave Devices (TSMD) sector of the Palo Alto-based Microwave Products Group. This effort concluded successfully on October 31 with the sale of the TSMD operation to Stellex Industries, Inc., which is operating the unit as Stellex Microwave Systems.

The divestiture of the TSMD business was a key event. We completed Watkins-Johnson's strategic goal to reconfigure the company as a high-technology commercial enterprise with two principal markets: semiconductor-manufacturing equipment and radio-frequency (RF) products for wireless-infrastructure applications. These two markets, although cyclical, embody the high-growth characteristics we seek.

Semiconductor Equipment

The overall market for semiconductor-manufacturing equipment was flat to slightly higher in 1997. However, much of that strength came from chip manufacturers accelerating their shift to smaller-geometry designs at least a year sooner than expected.

The versatility of Watkins-Johnson's batch-process atmospheric-pressure chemical-vapor-deposition (APCVD) equipment allowed our customers to adjust their processes to make the desired size changes. That is the good news. The resulting bad news is that WJ did not participate strongly in the market for reconfiguring semiconductor-fabrication facilities with new equipment; instead, our customers ordered upgrade modifications to existing systems for their process changes.

The Semiconductor Equipment Group accomplished a major goal for 1997 with the installation of WJ-2000 high-density plasma (HDP) cluster platforms at two Asian locations. We are currently pursuing additional WJ-2000 placements in 1998 with customers in the Asia-Pacific region and the United States. They will be used in intermetal-dielectric (IMD) deposition and shallow-trench isolation (STI) applications. Customer acceptance of the equipment for IMD and STI would more

Dr. W.Keith Kennedy, Jr., President and Chief Executive Officer, right.

Dr. Dean A. Watkins, Founder and Chairman, right, Dr. H. Richard Johnson, Founder and Vice Chairman, left.

than double WJ's served available market.

While WJ is moving aggressively to achieve these technological advances, we need to recognize that the currency devaluation and financial-system problems occurring in Asia are adversely affecting our short-term expectations. Monetary weakness is undermining key Korean customers' planned spending for new semiconductor-fabrication facilities.

Although I believe that the Asian monetary problems will be overcome, they cause us to expect another weak year in 1998 for our semiconductor-equipment business. We will, however, meet the challenge of sustaining our product development to position ourselves for the future.

Wireless Communications

WJ's wireless-communications sector operates at two locations. The Wireless Products Group (WPG) of Palo Alto, California emphasizes wireless components and subassemblies based upon our proprietary gallium-arsenide (GaAs) semiconductor capability. The Telecommunications Group (TG), located in Gaithersburg, Maryland, produces communications receivers and transceivers and the recently introduced $Base_2$™.

The WPG team achieved impressive progress in 1997 as a high-volume manufacturer of superior radio-frequency products for wireless OEM requirements.. One of our customers, Lucent Technologies, recognized WPG's excellence by naming Watkins-Johnson its "Outstanding Supplier of 1997."

We plan to capitalize on the healthy RF component market by actively marketing WJ-manufactured GaAs devices. The year-end purchase of the assets of Samsung Microwave Semiconductor, Inc. (SMS) is a strategic move to enlarge our capacity. In addition to expanding the capability to build our own devices, the purchase gives WJ a non-exclusive license to manufacture SMS products and service their customers.

A major accomplishment at TG in 1997 was the completion of the $Base_2$ cellular base station development and the system's successful installation in Dalian, China by Telos Engineering, Ltd. as part of its *Sonata* Wireless Telecommunications System. The $Base_2$ features a seamless migration path from analog cellular (AMPS) to digital (TDMA) using the IS-136 standard.

Above-plan sales and profit performance by TG's communications-intelligence product lines kept the group's overall financial performance on track during the year. WJ continues to be a preferred supplier to security agency customers with its history of product excellence and understanding of their unique mission requirements. Our internal development practice fits well with the U.S. government's "commercial-off-the-shelf" buying philosophy.

In addition to the sale of TSMD to Stellex Microwave Systems, we liquidated two real estate assets. Two buildings at the leased Palo Alto plant were sold back to our landlord, Taylor-Woodrow, on December 29. The sale of 14 vacant acres in San Jose closed in the new fiscal year on January 9. These activities further strengthen WJ's already strong balance sheet.

The following pages will discuss our business units in more detail

W. Keith Kennedy, Jr.
President and Chief Executive Officer

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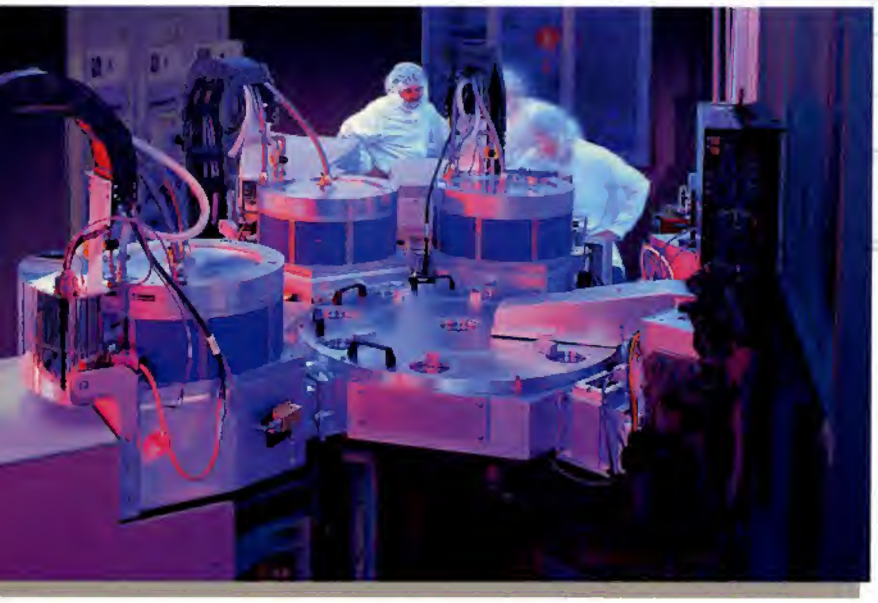
The company's Semiconductor Equipment Group (SEG) at present accounts for about 60 percent of Watkins-Johnson's revenue. Although WJ's CVD-equipment revenue climbed sequentially from quarter to quarter, total sales for the year amounted to $186 million, down 32 percent from 1996's total of $272 million.

Overall, WJ's performance in a soft market during 1997 was not as strong as some other equipment manufacturers, in part because many of the company's installed systems were capable of producing new, smaller-geometry designs without replacement. In addition, the worldwide over-supply of memory devices continued throughout 1997, causing DRAM manufacturers to defer factory upgrades and new construction, and the DRAM business is a significant portion of SEG's revenue potential. Moreover, the monetary crisis in Asia, and Korea in particular, suspended anticipated sales.

WJ equipment currently is a major contender in one market niche—called premetal-dielectric (PMD) deposition—in the semiconductor-manufacturing process. The company intends to maintain that position with a proliferation of improvements to its batch-process atmospheric-pressure chemical-vapor-deposition (APCVD) product line. Further, since customer satisfaction with this equipment is exceptionally high, WJ plans to leverage that satisfaction to gain acceptance for equipment to perform additional processes

The company accomplished a major goal in 1997 when WJ-2000 high-density plasma (HDP) cluster platforms were shipped and installed at two locations in Asia. Additional WJ-2000 placements are scheduled for early 1998. These 200-mm HDP systems are being used successfully in intermetal-dielectric (IMD) deposition and shallow-trench isolation (STI) applications. Acceptance as a supplier of IMD and STI equipment will more than double WJ's available market. In addition to the high-density plasma process module, SEG is developing additional process modules for the versatile WJ-2000 cluster platform.

Single-wafer processing at 300 mm will be required for new fabrication facilities and Watkins-Johnson is completing development of a variant of its



WJ's 200-mm HDP cluster platforms are being used successfully in intermetal-dielectric deposition and shallow-trench isolation applications.

scalable cluster platform to perform PMD, IMD, and STI deposition on these large wafers. The equipment—called the WJ-3000 system—is expected to begin running customer samples during 1998. Market researchers expect that a number of fabrication facilities will be operating developmental and pilot 300-mm lines by the year 2000.

Not only is WJ concentrating on employing its equipment to perform new CVD processes, the company is also diligently working to perfect its handling of new materials. As integrated-circuit designers employ smaller geometries and multiple layers to address future performance requirements, materials with improved dielectric performance—called low-k—are being employed in new devices. Also, better conducting metals—like copper—are being introduced to the production process. Customer sample runs of low-k dielectric films are scheduled for the year ahead. Future equipment must be compatible with these processes, and WJ is collaborating with other companies to ensure that compatibility.

While the company is moving aggressively to achieve all of these technological advances, its expectations in the short term are being adversely affected by the currency devaluations and financial-system breakdowns occurring in Asia. Monetary weakness has seriously undermined the ability of key Asian customers to maintain planned spending on high-ticket products like semiconductor equipment.

Asia historically has been a significant market for Watkins-Johnson's products, and semiconductor manufacturers in Korea have been particularly strong customers. But now, the disruption of the Korean business climate and the involvement of the IMF with its restrictions on Korean investment make the outlook for that market appear very weak in 1998.

Another lingering problem is the global oversupply of DRAMs. Computer-memory manufacturers have little incentive to expand or upgrade their production lines as long as demand for their product is being satisfied with existing capacity.

Limited near-term capital spending by memory producers and the shifting of the 300-mm transition further into the future afford WJ the opportunity to solidify its strength as a supplier of next-generation CVD equipment. While Watkins-Johnson plans to sustain its aggressive initiatives to establish the company as the dielectric-deposition vendor of choice worldwide, the company expects to concentrate its near-term efforts in 1998 on the United States, Taiwan and Europe.

The company accomplished a major goal in 1997 when WJ-2000 high-density plasma systems were shipped and installed at two locations in Asia.

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The February opening of WJ's Asian Technology Center in Japan brought to 19 the number of worldwide sales and service locations available around the clock to Semiconductor Equipment Group customers.

Watkins-Johnson's wireless-communications business segment now consists of the company's Palo Alto, California-based Wireless Products Group (WPG) and its Telecommunications Group (TG), located in Gaithersburg, Maryland. Revenue in 1997 from these units' continuing operations totaled $105 million, a 36-percent increase over 1996's $77 million.

Wireless Products Group

The WPG organization achieved significant revenue growth during 1997 as its radio-frequency assemblies for cellular and PCS systems gained further industry acceptance. WJ's cell-extender products attracted keen customer interest at the wireless industry's PCS Show in Dallas, and WJ is pursuing promising new large-quantity wireless-subsystems programs with OEM manufacturers in the United States and overseas.

The WPG team achieved impressive results in 1997 as a high-volume manufacturer of superior radio-frequency products for base-station, customer-premises and cell-extender requirements. Lucent Technologies recognized the excellence of WPG's products and service by naming Watkins-Johnson its "Outstanding Supplier for 1997" at its annual supplier-recognition awards ceremony at Mount Olive, New Jersey on October 30.

The company also is capitalizing on the healthy market for RF components by expanding its gallium-arsenide (GaAs) integrated-circuit fabrication capability and actively marketing WJ-manufactured devices to the wireless industry. The AH1 amplifier, for example, employs proprietary WJ technology in a high-performance RF amplifier targeted at wireless-infrastructure market applications. The product has been designed into several OEM base stations scheduled for high-rate production in 1998.

Historically, WJ has manufactured GaAs devices for its own use only. These devices offer excellent performance, and an updated and expanded fabrication facility can enable WJ to sell them on the open market at competitive prices.

WJ's Base$_2$MacroCell is a dual-mode AMPS/IS-136A software-definable base station for both mobile and fixed-wireless applications.

The December 1997 acquisition of Samsung Microwave Semiconductor increased WJ's capacity to produce high-performance gallium-arsenide devices in sufficient quantity to serve as a merchant supplier to the wireless products market.

As a way to accelerate the expansion of its integrated-circuit manufacturing capability, WJ explored potential acquisitions compatible with its existing Palo Alto fabrication facility. This search was successful, and the company at year-end purchased the assets of Samsung Microwave Semiconductor, Inc, whose ultimate parent is Samsung Electronics Company of Seoul, Korea. WPG has now begun the gradual transfer of its Palo Alto GaAs and thin-film operations to the newly acquired Milpitas facility.

Telecommunications Group

On-plan sales and profit performance by TG's communications-intelligence product lines kept the group's overall financial performance on track during the year. WJ continues to be the supplier of choice for many of its longtime government customers because of its long history of technical excellence and its understanding of their unique mission requirements.

The group's major technical accomplishment of the year was the completion of the analog version of the Base$_2$™ wideband cellular base station design and its successful installation by Telos Engineering, Ltd. in Dalian, China. This installation gives WJ an excellent inroad to future base-station business in China and other foreign markets.

Although the initial Base$_2$ installation was an analog system, in early 1998 WJ will introduce its new Base$_2$ MacroCell, the first commercially available dual-mode AMPS/IS-136A software-definable base station for both mobile and fixed-wireless applications. The Base$_2$ MacroCell Base Station System provides a seamless migration path from AMPS to TDMA by handling both protocols in a single base station and by configuring system resources based on user demand.

Orders in the group's well-established government segment were above plan in 1997. Going forward, the group will market communications systems, receiving equipment and subsystems as a value-added supplier and partner to customers in the intelligence and military communities. TG will emphasize programs with strong follow-on potential, particularly those that enhance its overall product strength for additional business opportunities.

The government segment—mobile military communications and emergency communications in particular—also represents an emerging market for TG's wireless-infrastructure capabilities. As government agencies continue to be strapped by tight budgets and limited R&D funding, a trend toward buying commercial, off-the-shelf (COTS) equipment has developed. COTS equipment, like our cellular subsystems and base stations, represents a cost-effective alternative to government buyers.

Watkins-Johnson outdoor and in-building repeaters expand cellular coverage by filling blind spots in service areas caused by hills, tunnels and buildings.

Financial Condition and Liquidity

During 1997, cash and equivalents increased by $118.8 million, from $15.7 million to $134.5 million. Net income for 1997 was $32.9 million, while net cash provided by operations was $57.1 million. Net income was $3.0 million and net cash provided by operations was $13.8 million in 1996, and net income was $31.4 million and net cash provided by operations was $12.8 million in 1995. For 1997, net cash provided by operating activities differed from net income for the period primarily because of increases for: depreciation and amortization charges of $13.1 million, $26.9 million of accounts receivables collections and $39.6 million in non-cash increases in accruals and payables; and decreases for: a $10.5 million net change in deferred taxes, $36.9 million for the gain and net income of discontinued operations (discussed below) and $11.2 million for net cash used by discontinued operations. For 1996, net cash provided by operating activities differed from net income for the period primarily because of increases for: depreciation and amortization charges of $9.0 million, net changes in inventory of $16.9 million and provisions for warranties and losses on contracts of $6.7 million; and decreases for: a $3.3 million net change in deferred taxes, $4.4 million and $2.2 million for the net income and cash used by discontinued operations, respectively, and $4.5 million and $4.3 million for net changes in receivables and accruals and payables, respectively. For 1995, net cash provided by operating activities differed from net income for the period primarily because of increases for: depreciation and amortization charges of $7.3 million, net changes in accruals and payables of $9.1 million and $25.7 million in net cash provided by discontinued operations; and decreases for: the net income of discontinued operations of $9.6 million, and $12.8 million and $35.6 million for net changes in receivables and inventory, respectively.

Net cash provided by investing activities was $67.9 million in 1997 compared to net cash used by investing activities of $53.1 million and $23.4 million in 1996 and 1995, respectively. In 1997, the company received proceeds of $77.9 million and $8.5 million from the sale of discontinued operations and asset retirements, respectively, offset in part by investments of $22.2 million in new capital equipment. Cash used for investing activities in 1996 and 1995 was primarily for capital expenditures.

The company used $7.0 million in financing activities in 1997 compared to cash provided by financing activities of $20.4 million and $10.7 million in 1996 and 1995, respectively. The company reactivated its stock repurchase program during the first quarter of 1997 and during the year repurchased 204,200 shares of its common stock for $5.7 million which was partially offset by $2.8 million in proceeds from stock option exercises. The goal is to repurchase approximately the same number of shares added by the exercise of options. During 1997, the company paid approximately $4 million in dividends. The primary source of cash provided by financing activities in 1996 was long-term borrowings of about $20 million for the purchase and construction of a new facility in Japan for the company's Semiconductor Equipment Group, while the primary source of cash provided by financing activities in 1995 was proceeds from stock option exercises.

At December 31, 1997, the company's principal source of liquidity consisted of $134.5 million in cash and cash equivalents. The company has arrangements with several banks to provide a $50,000,000 unsecured credit facility. This facility expires on December 8, 1998. During 1997, the company incurred no borrowings under this credit facility. Because of the operating loss reported in the fourth quarter of 1997 the company is not in compliance with certain terms under this credit facility. The company is coordinating with its banks to re-establish a compliant condition. Management does not anticipate any significant near term borrowing requirements and does not expect the current noncompliance condition to materially affect the company's liquidity or financial position for 1998. From time to time the company may enter into certain long-term borrowing arrangements with financial lending institutions for capital acquisitions of property, plant and equipment. At December 31, 1997, long-term borrowings consisted of two unsecured loans used for the company's land, building and equipment located in Kawasaki, Japan. The loans are denominated in Yen, of which approximately $6.6 million is amortizable in monthly installments through the year 2011, bears interest at 2.5%, and approximately $12 million requires a balloon payment due in the year 2006 and bears interest at 3.1%, payable semiannually. At December 31, 1997 there were no material commitments for capital expenditures.

Current Operations and Business Outlook

On October 31, 1997, the company completed the sale of its Palo Alto, Calif.-based Tactical Subsystems and Microwave Devices sectors to an affiliate of Mentmore Holdings Corporation for consideration of $103 million, consisting mostly of cash. The sale resulted in a pre-tax gain of approximately $49.9 million. The divested businesses now operate as Stellex Microwave Systems, Inc. (Stellex). In connection with the sale, the company transferred approximately $77 million of Government Electronics and Wireless Communications backlog to Stellex. Stellex remains a WJ customer for GaAs devices and thin-film substrates. The divestiture enables Watkins-Johnson to concentrate its resources on two chosen areas of technology: semiconductor-manufacturing equipment and wireless-infrastructure products.

In the fourth quarter of 1997 the company elected the early adoption of Statement of Financial Accounting Standards No. 131, "Disclosures about Segments of an Enterprise and Related Information," (SFAS 131), and restated its reportable business segments accordingly. Prior to the adoption of SFAS 131, the company reported operations in three industry segments: Semiconductor Equipment, Wireless Communications, and Government Electronics. The former Government Electronics segment was redefined according to SFAS 131 to consist of the business sectors sold to Stellex as described above. The divested business is reported as discontinued operations in the financial statements. For further information regarding discontinued operations and business segments, see Note 8 to the consolidated financial statements contained in Part II, Item 8 of this annual report on Form 10-K.

For 1997, the company reported sales and a net loss from continuing operations of $291.3 million and $4.0 million, respectively. The

company ended the year with $98 million of backlog for the continuing business compared to $152 million last year. The current backlog excludes $19 million in semiconductor equipment backlog from Korea which has been removed from the backlog until adequate financial terms can be worked out. Comparative 1996 sales and net loss from continuing operations were $349.1 million and $1.3 million, respectively.

The sale and exchange of a portion of the company's Palo Alto lease interest was successfully completed in December 1997. About 7 acres at the Palo Alto campus were turned back for consideration, resulting in a $7.6 million pre-tax gain reflected as "Gain on real property" in the statement of operations. As part of the deal the company was able to extend the lease so that the remaining 16 acres are available for over 50 years without lease payments.

Looking forward, long-term growth for the continuing businesses appears bright. The semiconductor equipment business is a cyclical business. The company anticipates that overall revenues in calendar year 1998 will experience a slight decrease as the anticipated decline of the semiconductor equipment business will more than offset the growth expected in the wireless business. Even with heavy investment for research and development, the Wireless Communications segment is expected to make a profit. However, those Wireless profits are not expected to overcome the losses anticipated in the Semiconductor Equipment Group. In any event, the 1998 profitability of WJ will come from the net interest on cash and the land sale in San Jose, which is discussed below.

SEMICONDUCTOR EQUIPMENT GROUP

Sales of semiconductor equipment in 1997 amounted to $186 million, down 32 percent from the $272 million recorded in 1996. The book-to-bill for the fourth quarter was only 0.7-to-1 as a result of events relating to Korea. Orders were $32 million during the fourth quarter of 1997, which were flat with the third quarter's $32 million, but were down compared to the $78 million of last year's fourth quarter. These order rates mean that the group is below the long-term goal of a 5-month backlog. At this level, the company is able to service the order requirements of its customers rapidly, and they continue to take advantage of the shorter lead time. This business segment is entering 1998 with a backlog totaling approximately $38 million.

The worldwide oversupply of memory devices continued throughout 1997, prompting DRAM manufacturers to expedite their transition to smaller-geometry devices. The overall capital-equipment market remained flat. Because the company's installed CVD equipment was adaptable to the production of the newer-generation memory devices, the company did not benefit from the retooling undertaken during the year. The general market weakness was exacerbated at year-end as the magnitude of the Asian economic crisis began to unfold, and IMF spending restrictions increased the uncertainty surrounding any near-term business prospects from Asian customers. As a result, the company took certain actions in the fourth quarter of 1997 to minimize its financial exposure. The company deferred shipment and revenue recognition with certain Asian customers, and the business is being sized to reflect these market changes. This resulted in certain non-performing assets being written off which consist primarily of inventory, capital assets and a small lease commitment in Scotts Valley, California. The effect of these actions resulted in a pre-tax impact of approximately $17 million during the fourth quarter of 1997. The group is reviewing its worldwide infrastructure to reduce cost while still maintaining quality service to its customers. The group is taking steps to insure that research and development spending will result in higher potential for certain projects, while other projects are to be either reduced or delayed. In spite of these actions, fixed costs and what are considered to be necessary development expenses will probably make the group unprofitable in 1998 due to the lower anticipated revenues.

The company continues to believe the long-range industry forecasts for the semiconductor industry remain bright. Current semiconductor integrated circuit demand appears to be increasing in dollar terms over last year. However, the industry is still in an overcapacity situation and is purchasing less capital equipment. Unfortunately, the near-term orders picture is lower than 1997's average run rate of about $47 million per quarter.

WIRELESS COMMUNICATIONS

Wireless-communications sales in 1997 totaled $105 million, a 36-percent increase over the prior year's comparable $77 million for this segment (as restated for the adoption of SFAS 131). Orders for the fourth quarter 1997 totaled approximately $36 million, compared to $31 million for the same period last year, and $22 million for the third quarter of 1997. The business segment is entering 1998 with a backlog totaling approximately $60 million.

The segment achieved exceptional revenue growth during 1997 as its radio-frequency assemblies for cellular and PCS systems gained widespread acceptance. Orders were good for the CDMA and TDMA assemblies, which are produced for Lucent Technologies. The company believes that a good shipment rate will continue throughout 1998 for these assemblies. The company is gaining business at other wireless OEMs and is beginning to receive additional orders for volume GaAs parts.

On December 31, the company purchased the assets of Samsung Microwave Semiconductor, and its gallium-arsenide semiconductor business. Although the company picked up a small amount of business, the primary reason for this acquisition was the in-process technology and equipment. Significant additional work will be necessary to successfully bring these products to market. The acquisition resulted in a $5.0 million pre-tax charge against operations consisting principally of in-process R&D. The acquisition of the Samsung facility and its GaAs capability enables the segment to expand its existing capacity.

In 1997, the company completed its Base,™ cellular base station design and the system was successfully installed in Dalian, China, by Telos Engineering, Ltd. as part of its Sonata Wireless Telecommunications System. There are several good opportunities for this equipment in other Chinese cities and in South and Central America where the company is supporting the work of its system integrator customers.

Hopes for major U.S. business for the $Base_2$™ system did not come to fruition when the customer was unable to get their major supplier to open their switching specification to WJ. The company is re-emphasizing the international marketing of the system. International customers seem more willing to work with the open-systems switches. The company is hopeful that these opportunities will materialize into orders in 1998.

1997 Compared to 1996

Wireless Communications sales increased 36% while Semiconductor Equipment Group sales decreased 32%, resulting in an overall company decrease of 17%. By the third quarter of 1996, the company began to experience the drop in semiconductor equipment shipments. Gross margins decreased from 34% to 32.5%. Gross margins in 1997 include the effects of $15 million in fourth quarter Semiconductor Equipment Group write-offs discussed above, compared to 1996 which included nearly $20 million in write-offs due mostly to slow-moving inventory and some termination costs. Selling and administrative expenses decreased 12%, due mostly to the decreased volume and cost-cutting efforts, but increased slightly as a percentage of sales. Excluding a write-off of $4.6 million for in-process research and development connected with the Samsung GaAs acquisition, research and development expenses remained relatively flat as a percentage of sales. Interest income increased $1.4 million over the prior year due to the increase in cash and cash equivalents. Other income decreased due primarily to about $1.4 million in foreign currency translation losses in 1997 from the company's Southeast Asian subsidiaries. The sale and exchange of a Palo Alto lease interest was successfully completed in 1997, resulting in a $7.6 million pre-tax gain reflected as "Gain on real property" in the consolidated financial statements. The effective tax rate for federal, state and foreign income taxes on continuing operations resulted in a tax benefit rate of about 43% compared to 37% in 1996. The 43% tax benefit rate resulted mostly from the effect of the operating loss with positive benefits from export sales and research credits, which were offset by taxes incurred by foreign operations. Due to the above factors, the net loss from continuing operations increased from $1.3 million for 1996 to about $4.0 million for 1997. Including the after tax gain on the disposition and results of discontinued operations, net income increased from $3.0 million for 1996 to $32.9 million for 1997.

1996 Compared to 1995

Semiconductor Equipment Group sales and Wireless Communications sales both increased 23% over the prior year. Gross margins decreased from 46.2% to 34% due mostly to slow-moving inventory write-offs and termination costs totaling nearly $20 million and an increased fixed cost base associated with early 1996 expansion efforts in anticipation of increased business by the Semiconductor Equipment Group. Although selling and administrative expenses decreased as a percentage of sales, due mostly to cost cutting efforts and lower foreign sales commissions resulting from direct sales efforts, 1996 expenses were slightly higher due to the increased volume and infrastructure development. Research and development expenses remained flat at about 15% of sales due to continuing efforts to develop next-generation products for both the semiconductor equipment and wireless communications segments. Interest expense increased over 1995 due to long-term borrowings. Other income decreased as 1995 results included $1.3 million from a favorable insurance settlement for certain environmental expenditures. The effective tax rate for federal, state and foreign income taxes on continuing operations resulted in a tax benefit rate of 37% in 1996 compared to a 28.5% tax expense rate in 1995. The 37% tax benefit rate resulted mostly from the effect of the operating loss with positive benefits from export sales and research credits, which were offset by taxes incurred by foreign operations. Due to the above factors, results of continuing operations decreased from income of $21.9 million for 1995 to a loss of $1.3 million for 1996. Including the results of discontinued operations, net income decreased from $31.4 million for 1995 to $3 million for 1996.

Subsequent Events

In January 1998, the company sold approximately 15 acres of undeveloped land adjacent to its San Jose, California, facility for a net sales price of about $16 million, resulting in a pre-tax gain of approximately $15 million. The transaction will be reported in the company's results for the first quarter ending March 27, 1998.

Year 2000 Computer Software Conversion

The company regularly updates its information systems capabilities, and has evaluated all significant computer software applications for compatibility with the year 2000. With the system changes implemented to date and other planned changes, the company anticipates that its computer software applications will be compatible with the year 2000. Expenditures specifically related to software modifications for year 2000 compatibility are not expected to have a material affect on the company's operations or financial position. However, the company is dependent on numerous vendors and customers which may incur disruptions as a result of year 2000 software issues. Accordingly, no assurance can be given that the company's results of operations will not be impacted by this industry-wide issue.

Risks and Uncertainties That May Affect Future Results

Statements in this Annual Report, including this "Management's Discussion and Analysis of Financial Condition and Results of Operations" which are not historical facts are forward-looking statements. The words "expect", "anticipate", "looking forward" and other similar expressions are intended to identify forward-looking statements that involve risks and uncertainties that may cause actual results to differ materially from those expressed. Such risks and uncertainties include, but are not limited to: product demand and market acceptance risks, the effect of economic conditions, the impact of competitive products and pricing, product development, commercialization and technological difficulties, capacity and supply constraints or difficulties, business cycles, the results of financing efforts, actual purchases under agreements, the effect of the company's accounting policies, U.S. Government export policies, geographic concentrations, natural disasters and other risks.

Consolidated Balance Sheets

(Dollars in thousands, except per share amounts)	1997	December 31 1996
ASSETS		
CURRENT ASSETS:		
Cash and equivalents	**$ 134,462**	$ 15,702
Receivables (net of allowance for doubtful accounts of $3,176 in 1997 and $747 in 1996)	**45,690**	73,217
Inventories:		
Finished goods	**9,283**	3,105
Work in progress	**18,519**	24,000
Raw materials and parts	**18,873**	23,153
Deferred income taxes	**24,830**	14,395
Net assets of discontinued operations (Note 8)		25,717
Other	**6,536**	4,925
Total current assets	**258,193**	184,214
PROPERTY, PLANT AND EQUIPMENT:		
Land	**12,102**	13,075
Buildings and improvements	**55,155**	54,035
Plant facilities, leased	**11,012**	13,060
Machinery and equipment	**100,526**	106,648
	178,795	186,818
Accumulated depreciation and amortization	**(82,382)**	(88,348)
Property, plant and equipment–net	**96,413**	98,470
OTHER ASSETS:		
Net assets of discontinued operations (Note 8)		4,100
Other	**3,606**	6,960
Total other assets	**3,606**	11,060
	$ 358,212	$ 293,744
LIABILITIES AND SHAREOWNERS' EQUITY		
CURRENT LIABILITIES:		
Accounts payable	**$ 16,188**	$ 16,560
Accrued expenses	**23,209**	10,362
Advances on contracts	**1,867**	1,432
Provision for warranties and losses on contracts	**15,898**	14,478
Payroll and profit sharing	**15,825**	10,094
Income taxes	**31,599**	8,306
Total current liabilities	**104,586**	61,232
LONG-TERM OBLIGATIONS	**33,234**	37,801
COMMITMENTS AND CONTINGENCIES (Notes 3 and 6)		
SHAREOWNERS' EQUITY:		
Preferred stock, $1.00 par value–authorized and unissued, 500,000 shares		
Common stock, no par value–authorized, 45,000,000 shares; outstanding: 1997, 8,261,036 shares; 1996, 8,329,248 shares	**40,631**	38,998
Retained earnings	**179,761**	155,713
Total shareowners' equity	**220,392**	194,711
	$ 358,212	$ 293,744

See notes to consolidated financial statements

Consolidated Statements of Operations

(Dollars in thousands, except per share amounts)	**1997**	1996	1995
			Year Ended December 31
Sales	**$ 291,271**	$ 349,119	$ 284,335
Costs and expenses:			
Cost of goods sold	**196,675**	230,556	153,080
Selling and administrative	**58,696**	66,687	60,114
Research and development	**50,182**	53,175	42,656
	305,553	350,418	255,850
Income (loss) from operations	**(14,282)**	(1,299)	28,485
Other income (expense):			
Interest income	**2,198**	789	2,400
Interest expense	**(1,425)**	(1,574)	(873)
Other income (expense) - net	**(1,062)**	(12)	552
Gain on real property (Note 3)	**7,609**		
Income (loss) from continuing operations before federal, state and foreign income taxes	**(6,962)**	(2,096)	30,564
Federal, state and foreign income tax credits (expense)	**3,000**	775	(8,710)
Income (loss) from continuing operations	**(3,962)**	(1,321)	21,854
Discontinued operations (Note 8):			
Income from discontinued operations, net of taxes	**7,210**	4,355	9,574
Gain on disposition, net of taxes	**29,677**		
Net income	**$ 32,925**	$ 3,034	$ 31,428
Basic per share amounts:			
Income (loss) from continuing operations	**$ (.48)**	$ (.16)	$ 2.75
Income from discontinued operations	**.87**	.53	1.21
Gain on disposition of discontinued operations	**3.60**		
Net income	**$ 3.99**	$ .37	$ 3.96
Basic average common shares	**8,258,000**	8,265,000	7,938,000
Diluted per share amounts:			
Income (loss) from continuing operations	**$ (.48)**	$ (.16)	$ 2.49
Income from discontinued operations	**.87**	.53	1.09
Gain on disposition of discontinued operations	**3.60**		
Net income	**$ 3.99**	$ .37	$ 3.58
Diluted average common shares	**8,258,000**	8,265,000	8,776,000

See notes to consolidated financial statements

Consolidated Statements of Cash Flows

(Dollars in thousands)			*Year Ended December 31*
	1997	1996	1995
OPERATING ACTIVITIES:			
Net income	**$ 32,925**	$ 3,034	$ 31,428
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	**13,112**	8,996	7,341
Gain on disposal of property, plant and equipment	**(3,513)**		
Deferred income taxes	**(10,470)**	(3,280)	(785)
Results of discontinued operations and gain on disposal	**(36,887)**	(4,355)	(9,574)
Net changes in:			
Receivables	**26,897**	(4,506)	(12,819)
Inventories	**3,364**	16,877	(35,636)
Other assets	**1,584**	(1,752)	(1,733)
Accruals and payables	**39,635**	(4,257)	9,127
Advances on contracts	**435**	(1,114)	(1,926)
Provision for warranties and losses on contracts	**1,420**	6,688	2,498
Environmental remediation	**(198)**	(327)	(817)
Net cash provided (used) by continuing operating activities	**68,304**	16,004	(12,896)
Net cash provided (used) by discontinued operations	**(11,180)**	(2,181)	25,670
Net cash provided by operating activities	**57,124**	13,823	12,774
INVESTING ACTIVITIES:			
Additions of property, plant and equipment	**(22,177)**	(48,303)	(23,366)
Restricted plant construction funds	**3,738**	(3,738)	
Proceeds from sale of discontinued operations	**77,884**		
Proceeds on asset retirements and other	**8,475**	(1,070)	(35)
Net cash provided (used) by investing activities	**67,920**	(53,111)	(23,401)
FINANCING ACTIVITIES:			
Long-term borrowings	**1,642**	20,241	
Payments on long-term borrowings	**(1,132)**	(135)	(112)
Proceeds from issuance of common stock	**2,778**	4,691	14,028
Repurchase of common stock	**(5,747)**		
Dividends paid	**(3,974)**	(3,973)	(3,829)
Other	**(531)**	(390)	627
Net cash provided (used) by financing activities	**(6,964)**	20,434	10,714
Effect of exchange rate changes on cash	**680**		
Net increase (decrease) in cash and equivalents	**118,760**	(18,854)	87
Cash and equivalents at beginning of year	**15,702**	34,556	34,469
Cash and equivalents at end of year	**$ 134,462**	$ 15,702	$ 34,556

See notes to consolidated financial statements

Continued

Consolidated Statements of Cash Flows *Continued*

(Dollars in thousands)	1997	1996	Year Ended December 31 1995
Other cash flow information:			
Income taxes paid-net of refunds	**$ 3,143**	$ 5,700	$ 5,828
Interest paid	**1,389**	1,574	872
Noncash investing and financing activities:			
Noncash effect on "Property, Plant and Equipment" and "Other Assets" due to a plant held for sale in 1994 and returned to service in 1995. Plant transferred at book value which is below market.			$ (5,107)

Consolidated Statements of Shareowners' Equity

(Dollars in thousands, except per share amounts)	Common Stock Shares	Common Stock Dollars	Retained Earnings	Total Shareowners' Equity
Balance, January 1, 1995	7,576,471	$ 20,279	$ 129,347	$ 149,626
Net income for 1995			31,428	31,428
Dividends declared–$.48 per share			(3,829)	(3,829)
Stock option transactions	547,584	14,028		14,028
Balance, December 31, 1995	8,124,055	34,307	156,946	191,253
Net income for 1996			3,034	3,034
Dividends declared–$.48 per share			(3,973)	(3,973)
Stock option transactions	205,193	4,691		4,691
Cumulative translation adjustments			(294)	(294)
Balance, December 31, 1996	8,329,248	38,998	155,713	194,711
Net income for 1997			32,925	32,925
Dividends declared–$.48 per share			(3,974)	(3,974)
Stock option transactions	135,988	2,778		2,778
Repurchase of common stock	(204,200)	(1,145)	(4,602)	(5,747)
Cumulative translation adjustments			(301)	(301)
Balance, December 31, 1997	8,261,036	$ 40,631	$ 179,761	$ 220,392

See notes to consolidated financial statements

Notes to Consolidated Financial Statements

1. Significant Accounting Policies

Principles of Consolidation—The consolidated financial statements include those of the company and its subsidiaries after elimination of intercompany balances and transactions. In 1997, the company disposed of its Government Electronics operating segment which has been reported as discontinued operations, as described more fully in Note 8.

Cash Equivalents—Cash equivalents consist of municipal bond funds and commercial paper acquired with remaining maturity periods of 90 days or less and are stated at cost plus accrued interest which approximates market value. Year-end cash and cash equivalents totaled $134.5 million and $15.7 million in 1997 and 1996, respectively. The company's investment guidelines limit investments with a single issuer, which is not the U.S. Government or any agency thereof, to the greater of $5,000,000 or 10 percent of the investment portfolio.

Inventories—Inventories are stated at the lower of cost, using first-in, first-out and average-cost basis, or market. Cost of inventory items is based on purchase and production cost. Long-term contract costs and selling and administrative expenses are excluded from inventory. Progress payments are not netted against inventory.

Property, Plant and Equipment—Property, plant and equipment are stated at cost. Provision for depreciation and amortization is primarily based on the straight-line and sum-of-the-years'-digits methods. Leases which at inception assure the lessor full recovery of the fair market value of the property over the lease term are capitalized and amortized over the lease term in accordance with Statement of Financial Accounting Standards No. 13 "Accounting for Leases." The provisions of this Statement derive from the view that a lease that transfers substantially all of the benefits and risks incidental to ownership should be accounted for as the acquisition of an asset and the incurrence of an obligation by the lessee.

Revenue Recognition—Revenues, from other than long-term contracts, are recorded upon shipment or completion of tasks as specified in the contract. Estimated product warranty costs are accrued at the time of shipment. Sales and allowable fees under cost-reimbursement contracts are recorded as costs are incurred. Long-term contract sales and cost of goods sold are recognized using the percentage-of-completion method based on the actual physical completion of work performed and the ratio of costs incurred to total estimated costs to complete the contract. Any anticipated losses on contracts are charged to earnings when identified.

Foreign Currency Translation—The functional currency for all foreign operations is the U.S. dollar with the exception of the company's subsidiary located in Japan which uses the local functional currency. Gains or losses, which result from the process of remeasuring foreign currency financial statements and transactions into U.S. dollars, are generally included in net income. For the Japanese subsidiary, the cumulative translation adjustments are recorded directly in retained earnings. For 1997 the company incurred a net translation loss of approximately $1.4 million resulting primarily from its Southeast Asian subsidiaries and is included in "Other income (expense)-net" in the Consolidated Statements of Operations. Translation gains or losses are not material for any prior years presented.

Forward Exchange Contracts—The company enters into forward exchange contracts to hedge sales transactions and firm commitments denominated in foreign currencies. Gains and losses on the forward contracts are recognized based on changes in exchange rates, as are offsetting foreign exchange gains and losses on the underlying transactions. The company does not engage in foreign currency speculation.

Income Taxes—The consolidated statements of operations include provisions for deferred income taxes using the liability method for transactions that are reported in one period for financial accounting purposes and in another period for income tax purposes. Prior to 1997 state and local income taxes were included in selling and administrative expenses. State taxes for 1996 and 1995 have been reclassified to conform to the 1997 presentation.

Per Share Information—Net income per share is computed using the basic and diluted weighted average number of common shares outstanding during the year in accordance with the recently issued Statement of Financial Accounting Standards No. 128 (SFAS 128), "Earnings Per Share." Basic net income per share excludes dilution and is computed using the weighted average number of common shares outstanding for the period. Diluted net income per share reflects the potential dilution that could occur if securities or other contracts to issue common stock (dilutive stock options) were exercised or converted into common stock. Per share amounts for prior periods have been restated in accordance with SFAS 128.

Use of Estimates—The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amount of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Notes to Consolidated Financial Statements

1. Significant Accounting Policies *Continued*

Stock-Based Compensation—The company continues to account for stock-based compensation granted to employees and directors under the intrinsic value method as defined in Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees."

Business Segment Reporting—The company has elected the early adoption of Statement of Financial Accounting Standards No. 131, "Disclosures about Segments of an Enterprise and Related Information." The Statement requires certain expanded disclosures about operating segments and requires that an enterprise's operating segments be determined in the manner in which management operates the business. Specifically, financial information is to be reported on the basis that is used internally by the chief operating decision maker in making decisions related to resource allocation and segment performance.

Recently Issued Accounting Standard—In June 1997, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 130 (SFAS 130), "Reporting Comprehensive Income." This Statement is effective for fiscal years beginning after December 15, 1997. The company will be required to comply with the provisions of this standard in 1998. The company has not assessed the effect that this new standard will have on its consolidated financial statements and or disclosures.

Reclassification—Certain amounts for 1996 and 1995 have been reclassified to conform to the 1997 presentation.

2. Financial Instruments

Financial instruments that potentially subject the company to concentrations of credit risk consist principally of cash and equivalents, receivables, and financial instruments used in hedging transactions. The company invests in a variety of financial instruments such as commercial paper and municipal bond funds, and, by policy, limits the amount of credit exposure with any one financial institution or commercial issuer. Concentration of credit risk with respect to trade receivables is limited due to the variety of customers and market segments into which the company's products are sold, as well as their dispersion across geographic areas. The company maintains an allowance for doubtful accounts based upon the expected collectibility of receivables.

The carrying value of cash and equivalents, receivables, accounts payable and short-term notes payable are a reasonable approximation of their fair market value due to the short-term maturities of those instruments. The carrying value of the company's long-term debt approximates fair value based on the interest rates currently available to the company for long-term debt with similar terms as those borrowings of the company. Considerable judgment is required in interpreting market data to develop estimates of fair value, so these estimates are not necessarily indicative of the amounts that could be realized or would be paid in a current market exchange.

The company is a party to financial instruments with off-balance-sheet risk in the normal course of business to reduce its exposure to fluctuations in foreign exchange rates. At December 31, 1997 and 1996, the company had forward exchange contracts to sell Japanese Yen with a market value of approximately $12.4 million and $17.9 million, respectively, for a contract amount of $12.8 million and $19.6 million, respectively. These contracts mature within one year. The market value of forward exchange contracts were obtained from published foreign exchange market rates. The company's risk in these contracts is the cost of replacing, at current market rates, these contracts in the event of default by the other party. Management believes the risk of incurring such losses is remote as the contracts are entered into with major financial institutions.

3. Long-Term Obligations and Lines of Credit

Long-term obligations, excluding amounts due within one year, consist of the following at December 31:

(in thousands)	**1997**	1996
Long-term borrowings	**$18,630**	$ 20,241
Deferred compensation	**1,977**	2,360
Environmental remediation	**7,437**	7,635
Long-term leases	**5,190**	7,565
Total	**$33,234**	$ 37,801

The current portion of long-term obligations is included in current liabilities. The expected maturity amounts are as follows: 1998, $4,145,000; 1999, $2,050,000; 2000, $2,040,000; 2001, $1,080,000; 2002, $1,200,000; thereafter, $26,864,000.

Long-term Borrowings—Consists of two unsecured loans used for the company's land, building and equipment located in Kawasaki, Japan. The loans are denominated in Yen. Approximately $6.6 million is amortizable in monthly installments through the year

Notes to Consolidated Financial Statements

3. Long-Term Obligations and Lines of Credit *Continued*

2011, which bears interest at 2.5%. Approximately $12 million requires a balloon payment due in the year 2006, which bears interest at 3.1%, payable semiannually.

Deferred Compensation—The company has several nonqualified deferred compensation and bonus plans covering selected members of management and key technical employees. The purpose of these plans is to reward and encourage talented employees to remain with the company. Such amounts are payable in accordance with various fixed payment schedules.

Environmental Remediation—As discussed in Note 6, the company is obligated to remediate groundwater contamination at its Scotts Valley and Palo Alto, California, facilities. The portion expected to be paid within one year is included in current liabilities.

Leases—Certain long-term leases for plant facilities are treated as capital leases for financial statement purposes. The leases expire during the years 2014 to 2029. Renewal options provide for lease extensions in which the leases expire during the years 2029 to 2056. The company also has noncancellable operating leases for plant facilities and equipment expiring through the year 2004. These leases may be renewed for various periods after the initial term.

During 1997 the company exchanged a portion of its subleasehold interest at its Palo Alto, California, facility for consideration consisting of cash and the sublessor's leasehold rights in the remaining parcels under the lease. The exchange resulted in a pretax gain of $7.6 million which is reported in the 1997 Consolidated Statements of Operations as "Gain on real property." The terms of this lease now provide for no lease payments through the year 2029 with a nominal bargain renewal option extending the terms through the year 2056. The other Palo Alto lease provides for below market lease payments through the year 2014 with a renewal option extending the lease to the year 2029.

Payment obligations under existing capital and operating leases as of December 31, 1997 are as follows:

(in thousands)	Capital Leases	Operating Leases
Lease payments:		
1998	$ 635	$ 1,206
1999	635	808
2000	635	636
2001	635	547
2002	635	121
Remaining years	7,457	108
Total	10,632	$ 3,426
Imputed interest	(5,294)	
Present value of lease payments (including current portion of $148)	$ 5,338	

Rent expense included in continuing operations for property and equipment relating to operating leases is as follows:

(in thousands)	**1997**	1996	1995
Real property	**$2,446**	$2,384	$1,195
Equipment	**1,041**	782	502
Total	**$3,487**	$3,166	$1,697

Lines of Credit—The company arranged with several banks to provide a $100,000,000 unsecured credit facility. This facility expires on December 8, 1998. No material compensating balances are required or maintained. Borrowings under this facility generally bear interest at the lower of the prime rate or London Interbank Offered Rates (LIBOR) plus 0.75%. During 1997, the company did not borrow under this credit facility and renegotiated to reduce the credit facility to $50,000,000. Because of the operating loss reported in the fourth quarter of 1997 the company is not in compliance with certain terms under this credit facility, and accordingly the banks are not required to fund requested borrowings. The company is coordinating with its banks to re-establish a compliant condition. Management does not anticipate any significant near term borrowing requirements and does not expect the current noncompliance condition to materially affect the company's liquidity or financial position.

The amount of outstanding letters of credit and other guarantees was not material at December 31, 1997. In addition to the $50,000,000 unsecured credit facility, the company's foreign subsidiaries maintain separate lines of credit totaling approximately $500,000.

Notes to Consolidated Financial Statements

4. Shareowners' Equity

Stock Repurchase Program—The Board of Directors has authorized the company to repurchase a maximum of 2,500,000 shares of company stock. Through December 31, 1997, 1,704,200 shares have been repurchased, of which 204,200 were repurchased in 1997. No shares were repurchased in 1996 and 1995. The program enables the company to acquire its common stock from time to time when appropriate.

Common Share Purchase Rights—For each share of company common stock outstanding, one Common Share Purchase Right (the Rights) is attached. The Rights expire October 20, 2006, and may be redeemed by the company for $.01 per Right at any time prior to 10 days after a person or group acquires 15% or more of the company's common stock. The Rights become exercisable and trade separately from the common stock if any person or group acquires 15% or more of the company's outstanding common stock, or announces a tender or exchange offer which would result in such person or group acquiring 15% or more of the company's common stock. When the Rights first become exercisable as a result of the announcement of a tender or exchange offer, a holder of a Right will be entitled to buy one share of the company's common stock for $160. If, instead or thereafter, a person or group not previously approved by the Board of Directors acquires 15% or more of the company's shares, a holder of a Right (other than that person or group) will be entitled to buy that number of shares of common stock from the company which have a market value of twice the $160 exercise price of each Right. If the company is acquired in a merger or other business combination after any person or group acquires 15% or more of the company's common stock, each Right will entitle its holder to buy a number of shares of common stock of the surviving company having a market value of twice the $160 exercise price. After the acquisition by any person or group of 15% or more of the company's common stock and up to the time that such person or group acquires a 50% interest, the company will also have the ability to exchange some or all of the Rights (other than Rights held by the acquiror) for one share of common stock per Right at no expense to the holder.

Stock Option Plans—The Employee Stock Option Plans (the Plans) provide for grants of nonqualifying and incentive stock options to certain key employees and officers. The company may grant options to purchase up to 4,300,000 shares of common stock. During 1997 the company increased the number of shares it may grant from 3,900,000 shares to 4,300,000 shares through the adoption of a new nonqualified stock option plan for nonofficer employees. The options are granted at the market price on the date of grant and expire at the tenth anniversary date. One-third of the options granted are exercisable on each of the second, third and fourth anniversary dates following the grant. The Plans allow those employees who are subject to the insider trading restrictions certain limited rights to receive cash in the event of a change in control. Shares issued are net of retirement of shares used in payment for options exercised. In addition, the Plans permit the award of restricted stock rights subject to a fixed vesting schedule. The holder of vested restricted stock has certain dividend, voting, and other shareowner rights. No restricted stock awards have been made through December 31, 1997.

The Nonemployee Directors Stock Option Plan provides for a fixed schedule of options to be granted through the year 2005. Nonemployee directors of the company are automatically granted 3,000 shares of common stock each year that such person remains a director of the company. The options are granted at the market price on the date of grant and expire on the tenth anniversary date. The options granted become exercisable after six months from the date of grant. Prior to 1996, options granted were exercisable similarly to the Employee Stock Option Plans. The total number of shares to be issued under this plan may not exceed 350,000 shares. Included in the tables below, 21,000 option shares were granted at $26.88 in 1997, 21,000 option shares were granted at $34.63 in 1996; and 12,600 and 5,440 option shares were granted at $39.75 and $39.88, respectively, in 1995.

Included in the Consolidated Statements of Shareowners' Equity are tax benefits related to sales under stock option plans of $719,000, $1,161,000 and $4,735,000 for 1997, 1996 and 1995, respectively.

Activity related to all stock option plans is as follows:

1997	Shares	Weighted Average Exercise Price
Granted	242,000	$26.41
Exercised	135,988	$15.14
Terminated	191,309	$34.76
At December 31:		
Outstanding	1,443,940	$27.33
Exercisable	693,966	$23.70
Reserved for future grants	1,147,282	
1996		
Granted	205,000	$25.54
Exercised	209,393	$17.57
Terminated	328,443	$29.39
At December 31:		
Outstanding	1,529,237	$27.32
Exercisable	463,119	$19.11
1995		
Granted	680,290	$40.13
Exercised	566,198	$17.81
Terminated	87,346	$24.35
At December 31:		
Outstanding	1,862,073	$26.79
Exercisable	249,704	$21,25

Notes to Consolidated Financial Statements

4. Shareowners' Equity *Continued*

The following table summarizes information concerning currently outstanding and exercisable options at December 31, 1997:

Options Outstanding				Options Exercisable	
Range of Exercise Prices	Number Outstanding	Weighted Average Years of Remaining Contractual Life	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
$10.00 to $21.63	362,410	5.86	$15.12	247,410	$12.12
$22.75 to $25.13	488,170	7.15	$23.66	218,155	$22.97
$25.50 to $36.75	456,157	7.35	$34.63	183,569	$34.01
$37.25 to $55.00	137,203	7.68	$48.35	44,832	$48.95
$10.00 to $55.00	1,443,940	6.94	$27.33	693,966	$23.70

As discussed in Note 1, the company applies Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees," and related interpretations in accounting for its plans. Accordingly, no compensation expense has been recognized for its stock-based compensation plans. Had compensation cost for the company's stock option plans been determined based upon the fair value at the grant date for awards under these plans, and amortized to expense over the vesting period of the awards consistent with the methodology prescribed under Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation," the company's pro forma net income for 1997, 1996 and 1995 would have been $31,724,000, $1,256,000 and $29,849,000, respectively, or $3.84, $.15 and $3.76 per basic share, respectively, and $3.84, $.15 and $3.40 per diluted share, respectively. However, the impact of outstanding non-vested stock options granted prior to 1995 has been excluded from the pro forma calculation; accordingly, the 1997, 1996 and 1995 pro forma adjustments are not indicative of future period pro forma adjustments, when the calculation will apply to all applicable stock options. The weighted average fair value of options granted during 1997, 1996 and 1995 is calculated as $8.02 per share, $7.96 per share and $13.96 per share, respectively, on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions:

	1997	1996	1995
Dividend yield	**1.2 %**	1.5 %	1.7 %
Volatility	**38.1 %**	37.5 %	37.5 %
Risk free interest rate at the time of grant	**6.1 %**	6.2 %	7.1 %
Expected term to exercise (in months from the vest date)	**4.5**	3.5	3.5

The company's calculations are based on a multiple option valuation approach and forfeitures are recognized as they occur.

The Black-Scholes model used by the company to calculate option values, as well as other currently accepted option valuation models, were developed to estimate the fair values of freely tradable, fully transferable options without vesting restrictions, which significantly differ from the company's stock option awards. These models also require highly subjective assumptions, including future stock price volatility, and expected time until exercise, which greatly affect the calculated values.

Notes to Consolidated Financial Statements

5. Income Taxes

The provision for income taxes includes deferred taxes reflecting the net tax effects of temporary differences that are reported in one period for financial accounting purposes and in another period for income tax purposes. Deferred tax assets are recognized when management believes realization of future tax benefits of temporary differences is more likely than not. In estimating future tax consequences, generally all expected future events are considered other than enactments of changes in the tax law or rates. The components of income (loss) from continuing operations before federal, state and foreign income taxes consists of the following:

(in thousands)	**1997**	1996	1995
U.S.	**$ (10,330)**	$ (4,662)	$ 29,230
Foreign	**3,368**	2,566	1,334
Total	**$ (6,962)**	$ (2,096)	$ 30,564

The provision for federal, state and foreign income tax expense (credits) on income from continuing operations consists of the following:

(in thousands)	**1997**	1996	1995
Current:			
U.S.	**$ 425**	$ 1,928	$ 9,230
State	**1,275**	(152)	300
Foreign	**1,870**	1,264	517
Total current	**3,570**	3,040	10,047
Deferred:			
U.S.	**(4,385)**	(3,497)	(1,295)
State	**(2,185)**	(318)	(42)
Total	**$ (3,000)**	$ (775)	$ 8,710

Deferred foreign taxes were not significant for all years presented.

Deferred tax assets (liabilities) are comprised of the following at December 31:

(in thousands)	**1997**	1996	1995
Deferred compensation	**$ 2,556**	$ 1,915	$ 2,859
Loss accruals	**18,041**	10,495	4,853
Environmental remediation	**3,274**	3,147	3,298
Uniform capitalization	**1,212**	1,007	1,356
Vacation accrual	**1,663**	1,580	1,594
Other	**3,334**	2,111	1,406
Gross deferred tax assets	**30,080**	20,255	15,366
Depreciation	**(2,610)**	(3,197)	(2,097)
Other		(58)	(84)
Gross deferred tax liabilities	**(2,610)**	(3,255)	(2,181)
Net deferred tax asset	**$ 27,470**	$ 17,000	$ 13,185

The differences between the effective income tax (benefit) rate and the statutory federal income tax rate are as follows:

	1997	1996	1995
Statutory federal tax (benefit) rate	**(35.0)%**	(34.0)%	35.0 %
Export sales benefit	**(6.5)**	(10.0)	(7.4)
Research credit	**(8.5)**	(14.6)	(2.0)
Effect of foreign operations taxed at various rates	**9.8**	18.7	.2
State taxes (benefit) net of federal tax	**(8.4)**	(4.8)	.6
Other	**5.5**	7.7	2.1
Effective tax (benefit) rate	**(43.1)%**	(37.0)%	28.5 %

6. Environmental Remediation and Other Contingencies

The company remains in compliance with the remedial action plans being monitored by various regulatory agencies at its Scotts Valley and Palo Alto sites. In 1991 the company recorded a $15 million charge for estimated remediation actions and cleanup costs. No additional provision has been recorded since 1991. Expenditures charged against the provision totaled $198,000, $327,000 and $778,000 for the years 1997, 1996 and 1995, respectively. While the timing and ultimate amount of expenditures of restoring

Notes to Consolidated Financial Statements

6. Environmental Remediation and Other Contingencies *Continued*

the sites cannot be predicted with certainty, management believes that the provision taken is adequate based on facts known at this time. Included in other income for 1995 are recoveries from insurers totaling $1,331,000. The company will continue to vigorously pursue any potential recoveries from insurers or other responsible parties. Changes in environmental regulations, improvements in cleanup technology and discovery of additional information concerning these sites and other sites could affect the estimated costs in the future.

In addition to the above environmental matters, the company is involved in various legal actions which arose in the ordinary course of its business activities. Except for the environmental provision noted above, management believes the final resolution of these matters should not have a material impact on its results of operations, cash flows, and financial position.

7. Employee Benefit Plans

Employees' Investment Plan—The Watkins-Johnson Employees' Investment Plan conforms to the requirements of the Employee Retirement Income Security Act of 1974 (ERISA) and the Internal Revenue Code as a qualified defined contribution plan. The Plan covers substantially all employees and provides that the company match employees' 401(k) salary deferrals up to 3% of eligible employee compensation. The amount charged to income from continuing operations was $2,001,000, $1,920,000 and $1,680,000 in 1997, 1996 and 1995, respectively.

Employee Stock Ownership Plan (ESOP)—The ESOP was established to encourage employee participation and long-term ownership of company stock. The Board determines each year's discretionary contribution depending on the performance and financial condition of the company. The contribution is consistently determined as a percentage of eligible employee base compensation. All employees on the U.S. payroll of the company are eligible to participate in the plan and vesting is immediate. The Board approved a contribution equal to 1% of eligible employee compensation for 1997, 1996, and 1995, which resulted in charges to income from continuing operations of $657,000, $639,000 and $553,000, respectively. The ESOP held 229,231 and 220,941 shares of common stock at December 31, 1997 and 1996, respectively, and there are no unallocated or unearned shares held by the plan. There are no material matters affecting comparability of information for all years presented. Shares held by the ESOP are included in the company's earnings per share computations. Dividends paid with respect to common stock held by the ESOP are used to purchase additional shares and were not material for all years presented. The ESOP is a qualified defined contribution plan under ERISA and the Internal Revenue Code.

8. Business Segment Reporting

In the fourth quarter of 1997 the company elected the early adoption of Statement of Financial Accounting Standards No. 131, "Disclosures about Segments of an Enterprise and Related Information," (SFAS 131). The Statement requires that an enterprise's operating segments be determined in the manner in which management operates the business. Specifically, financial information is to be reported on the basis that is used internally by the chief operating decision maker in making decisions related to resource allocation and segment performance. The company's reportable segments are operated and managed as strategic business units and are organized based on products and services. Business units operated at different locations are aggregated for reporting purposes when their products and services are similar.

Under SFAS 131, the company's operations were divided into three industry segments: Semiconductor Equipment, Wireless Communications, and Government Electronics. As discussed below, the Government Electronics segment was divested during 1997. At the end of 1997, the company's operations consist of two industry segments: Semiconductor Equipment and Wireless Communications. Operations in the Semiconductor Equipment segment involve the development, production, sales and service of chemical-vapor-deposition equipment used in the manufacture of semiconductor products. Operations in the Wireless Communications segment involve the design, development, manufacture and sale of advanced wireless telecommunication products for cellular service providers, personal communication systems, and other radio-frequency products for commercial and government communications requirements. The Wireless Communications segment is composed of the Palo Alto, California-based Wireless Products Group and the Gaithersburg, Maryland, Telecommunications Group, including that group's communications-intelligence business.

Prior to the adoption of SFAS 131, the company reported segment information under Statement of Financial Accounting Standards No. 14, "Financial

Notes to Consolidated Financial Statements

8. Business Segment Reporting *Continued*

Reporting for Segments of a Business Enterprise," which required disclosures based on identifiable industry segments. Accordingly, the company previously reported operations in three industry segments: Semiconductor Equipment, Wireless Communications, and Government Electronics. The former Government Electronics segment was redefined according to SFAS 131 to be comprised of the company's Palo Alto, Calif.-based Tactical Subsystems and Microwave Devices sectors. On October 31, 1997 the company completed the sale of its Government Electronics segment to an affiliate of Mentmore Holdings Corporation for consideration of $103 million, consisting mostly of cash. The sale resulted in a pre-tax gain of approximately $49.9 million. The divested business is reported as discontinued operations in the accompanying financial statements. Operations of the divested business included the design, development, manufacture and sale of advanced microwave devices and tactical electronic systems and devices for guided-missile programs and other government applications. The divested Government Electronics business included some microwave devices business previously included as part of the Wireless Communications segment. The communications-intelligence receivers business now included in the Wireless Communications segment was formerly reported as part of the company's Government Electronics segment. Amounts reported for 1996 and 1995 have been restated to conform to the 1997 presentation.

Management evaluates segment performance based primarily on segment revenues, pre-tax operating profit or loss before interest and other nonoperating income and expenses, and return on assets. Sales between continuing segments are not significant for any year presented. Continuing operations by business segment are as follows:

(in thousands)

	Sales	Pre-tax Income	Year-End Assets	Capital Additions	Depreciation
Year Ended December 31, 1997					
Semiconductor Equipment	$ 186,454	$(13,328)	$ 132,528	$ 15,152	$ 10,144
Wireless Communications	104,817	(954)	54,408	6,881	2,510
Corporate			171,276	144	458
Income from continuing operations		(14,282)			
Other income (expense)—net		7,320			
Total	$ 291,271	$ (6,962)	$ 358,212	$ 22,177	$ 13,112
Year Ended December 31, 1996					
Semiconductor Equipment	$ 272,436	$ 7,212	$ 174,549	$ 46,122	$ 7,231
Wireless Communications	76,683	(8,511)	50,754	1,941	1,252
Corporate			68,441	240	513
Income from continuing operations		(1,299)			
Other income (expense)—net		(797)			
Total	$ 349,119	$ (2,096)	$ 293,744	$ 48,303	$ 8,996
Year Ended December 31, 1995					
Semiconductor Equipment	$ 222,212	$ 34,236	$ 147,051	$ 18,518	$ 4,687
Wireless Communications	62,123	(5,438)	42,644	4,522	2,253
Corporate		(313)	79,870	326	401
Income from continuing operations		28,485			
Other income (expense)—net		2,079			
Total	$ 284,335	$ 30,564	$ 269,565	$ 23,366	$ 7,341

Corporate assets consist primarily of cash, cash equivalents and deferred taxes, and included in 1996 and 1995 balances are net assets of the discontinued Government Electronics segment.

Notes to Consolidated Financial Statements

8. Business Segment Reporting *Continued*

Sales to individual customers representing greater than 10% of company consolidated sales are as follows:

(in thousands)	1997	1996	1995
Semiconductor Equipment:			
Marubeni Hytech (a Japanese distributor)	**$ 21,000**	$ 47,000	$ 61,000
Hyundai Electronics Industries Co., Ltd. (and affiliates)	**15,000**	37,000	28,000
Wireless Communications:			
United States Government	**36,000**	28,000	29,000

Sales from continuing operations to unaffiliated customers by geographic area are as follows:

(in thousands)	1997	1996	1995
United States	**$ 169,001**	$ 143,510	$ 116,479
Export sales from United States:			
Europe	**8,924**	29,759	13,762
Japan	**23,035**	65,952	56,956
Korea	**29,531**	52,572	53,259
Other Asia-Pacific Countries	**13,955**	35,767	28,980
Other	**3,307**	3,728	5,792
Europe	**34,701**	9,759	6,734
Japan	**2,742**	3,312	
Other Asia-Pacific Countries	**6,075**	4,760	2,373
Total	**$ 291,271**	$ 349,119	$ 284,335

Intercompany transfers of products and services between geographic regions were $59,040,000, $37,533,000 and $12,130,000 in fiscal years 1997, 1996 and 1995, respectively, and are accounted for at prices the company believes to be arm's length.

Operating profit and year-end long-lived assets by geographic area are as follows:

	Operating Profit	
(in thousands)	1997	1996
United States	**$ (19,385)**	$ (4,231)
Europe	**3,640**	700
Japan	**185**	952
Other Asia-Pacific Countries	**1,278**	1,280
Total	**$ (14,282)**	$ (1,299)

	Year-end long-lived assets	
(in thousands)	1997	1996
United States	**$ 118,606**	$ 121,483
Europe	**1,729**	2,290
Japan	**26,493**	30,076
Other Asia-Pacific Countries	**3,762**	4,159
Total	**$ 150,590**	$ 158,008

For 1995, foreign operations' sales, profits, and identifiable long-lived assets are less than ten percent of consolidated totals. Long-lived assets exclude financial instruments, deferred tax assets, and for 1996 exclude the net assets of discontinued operations totaling $29,817,000.

Summarized below are operating results and assets of the discontinued government electronics business. Intersegment sales were transferred based on negotiated prices.

	Year Ended December 31		
(in thousands)	1997	1996	1995
Net sales	**$ 75,700**	$ 89,200	$ 102,696
Gross profit	**$ 21,900**	$ 21,100	$ 32,200
Income from operations before income taxes	**$ 11,500**	$ 6,663	$ 15,189
Income taxes	**(4,290)**	(2,308)	(5,615)
Gain on disposition-net of taxes of $20,219	**29,677**		
Net income from discontinued operations	**$ 36,887**	$ 4,355	$ 9,574
Year-end net assets		$ 29,817	$ 23,281

Notes to Consolidated Financial Statements

9. Earnings Per Share

Basic and diluted earnings per share from continuing operations were computed as follows:

(in thousands, except per share amounts)	**1997**	1996	1995
		Year Ended December 31	
Basic per share amounts:			
Income (loss) from continuing operations (numerator)	**$ (3,962)**	$ (1,321)	$ 21,854
Weighted average shares outstanding (denominator)	**8,258**	8,265	7,938
Basic income (loss) per share	**$ (.48)**	$ (.16)	$ 2.75
Diluted per share amounts:			
Income (loss) from continuing operations (numerator)	**$ (3,962)**	$ (1,321)	$ 21,854
Weighted average shares outstanding	**8,258**	8,265	7,938
Effect of dilutive stock options			838
Diluted shares outstanding (denominator)	**8,258**	8,265	8,776
Diluted income (loss) per share	**$ (.48)**	$ (.16)	$ 2.49

For 1997 and 1996 the incremental shares from the assumed exercise of 251,000 and 272,000 stock options, respectively, are not included in computing the dilutive per share amounts because continuing operations resulted in a loss and such assumed conversion would be antidilutive. Additionally, weighted average options outstanding to purchase 564,000, 685,000 and 53,000 shares of common stock were not included in the computation of diluted per share amounts in 1997, 1996, and 1995, respectively, because the weighted average exercise prices were greater than the average market prices of the common shares. Weighted average exercise prices of $39.61 in 1997, $39.62 in 1996 and $50.80 in 1995 exceeded the average market prices of $29.75, $28.62 and $43.95, respectively.

10. Subsequent Events

In January 1998, the company sold approximately 15 acres of undeveloped land adjacent to its San Jose, California, facility for a net sales price of about $16 million realizing a pre-tax gain of approximately $15 million. The transaction will be reported in the company's results for the first quarter ending March 27, 1998.

11. Quarterly Financial Data – Unaudited

Unaudited quarterly financial data are as follows:

(in thousands, except per share amounts)

1997 Quarters	1st	2nd	3rd	4th
Sales	$ 67,216	$ 72,679	$ 79,176	$ 72,200
Gross profit	22,905	26,068	30,435	15,188
Income (loss) from continuing operations	(318)	886	1,762	(6,292)
Income from discontinued operations	2,796	2,196	1,828	30,067
Net income	2,478	3,082	3,590	23,775
Basic income (loss) per share from continuing operations	$ (.04)	$ .11	$ .21	$ (.76)
Diluted income (loss) per share from continuing operations	$ (.04)	$ .10	$ .21	$ (.76)
Basic net income per share	$ .30	$ .37	$ .44	$ 2.88
Diluted net income per share	$ .30	$ .36	$ .42	$ 2.88

1996 Quarters	1st	2nd	3rd	4th
Sales	$ 99,642	$ 107,047	$ 76,162	$ 66,268
Gross profit	40,110	35,888	29,541	13,024
Income (loss) from continuing operations	5,220	(761)	2,116	(7,896)
Income from discontinued operations	1,214	1,119	716	1,306
Net income	6,434	358	2,832	(6,590)
Basic income (loss) per share from continuing operations	$ .64	$ (.09)	$ .25	$ (.95)
Diluted income (loss) per share from continuing operations	$ .61	$ (.09)	$ .25	$ (.95)
Basic net income per share	$ .79	$ .04	$ .34	$ (.79)
Diluted net income per share	$ .75	$ .04	$ .33	$ (.79)

Notes to Consolidated Financial Statements

11. Quarterly Financial Data – Unaudited *Continued*

Due to the continued overcapacity in the semiconductor memory market, compounded by the Asian financial crisis, the company took certain actions in the fourth quarter of 1997 to minimize its financial exposure. The company deferred shipment and revenue recognition with certain Asian customers as a result of financing issues with these customers. The company's semiconductor equipment business is being sized to reflect these market changes and resulted in certain non-performing assets being written off which consist primarily of inventory and capital assets. The effect of the above actions resulted in a pretax impact of approximately $17 million during the fourth quarter.

The fourth quarter of 1997 also includes a pretax charge of $5 million related to the acquisition of Samsung Microwave Semiconductor (of which $4.6 million is for in-process research and development), and a $7.6 million pretax gain on the sale and exchange of certain leasehold interests on the Palo Alto, California, facility.

The fourth quarter of 1996 includes a charge of $11 million relating to slow-moving inventories and severance costs.

The total of quarterly amounts for diluted net income per share will not necessarily equal the annual amount. The computations exclude common equivalent shares in loss periods since they are antidilutive, and the computations are based on the average number of basic and diluted common shares outstanding during each period.

Independent Auditors' Report

The Shareowners and Board of Directors
of Watkins-Johnson Company:

We have audited the accompanying consolidated balance sheets of Watkins-Johnson Company and subsidiaries as of December 31, 1997 and 1996, and the related consolidated statements of operations, shareowners' equity, and cash flows for each of the three years in the period ended December 31, 1997. These financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Watkins-Johnson Company and subsidiaries at December 31, 1997 and 1996, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 1997 in conformity with generally accepted accounting principles.

In 1997, the company adopted Statement of Financial Accounting Standards No. 131, "Disclosures about Segments of an Enterprise and Related Information," as described in Note 8 to the consolidated financial statements.

Deloitte & Touche LLP

Deloitte & Touche LLP
San Jose, California
February 9, 1998

Selected Financial Data *(Unaudited)*

(Dollars in thousands, except per share amounts)	**1997**	1996	1995	1994	*Years Ended December 31* 1993
OPERATING RESULTS					
Sales	**$ 291,271**	$ 349,119	$ 284,335	$ 209,330	$ 150,303
Net income (loss) from continuing operations	**(3,962)**	(1,321)	21,854	19,652	12,382
Net income and gain from discontinued operations, net of taxes	**36,887**	4,355	9,574	1,309	(786)
Net income	**32,925**	3,034	31,428	20,961	11,596
Basic net income (loss) per share from continuing operations	**(.48)**	(.16)	2.75	2.65	1.64
Diluted net income (loss) per share from continuing operations	**(.48)**	(.16)	2.49	2.41	1.56
Basic net income per share	**3.99**	.37	3.96	2.82	1.53
Diluted net income per share	**3.99**	.37	3.58	2.57	1.46
Dividends per share	**.48**	.48	.48	.48	.48
Basic average common shares	**8,258,000**	8,265,000	7,938,000	7,425,000	7,558,000
Diluted average common shares	**8,258,000**	8,265,000	8,776,000	8,153,000	7,925,000
FINANCIAL POSITION					
Working capital	**$ 153,607**	$ 122,982	$ 124,796	$ 102,361	$ 95,206
Total assets	**358,212**	293,744	269,565	220,223	206,728
Long-term obligations	**33,234**	37,801	20,469	21,332	24,997
Shareowners' equity	**220,392**	194,711	191,253	149,626	133,888
Shareowners' equity per share	**26.68**	23.38	23.54	19.75	17.62
Number of shareowners	**6,500**	5,400	4,900	4,600	4,600

REPORT OF MANAGEMENT

The consolidated financial statements of Watkins-Johnson Company and subsidiaries were prepared by management, which is responsible for their integrity and objectivity. The statements were prepared in conformity with generally accepted accounting principles and, as such, include amounts that are based on the best judgments of management.

The system of internal controls of the company is designed to provide reasonable assurance that assets are safeguarded and that transactions are executed in accordance with management's authorization and are reported properly. The most important safeguard for shareowners is the company's emphasis in the selection, training and development of professional accounting managers to implement and oversee the proper application of its internal controls and the reporting of management's stewardship of corporate assets and maintenance of accounts in conformity with generally accepted accounting principles.

Deloitte & Touche LLP, independent auditors, are retained to provide an objective, independent review as to management's discharge of its responsibilities insofar as they relate to the fairness of reported operating results and financial position. They obtain and maintain an understanding of the company's accounting and financial controls, and conduct such tests and related procedures as they deem necessary to arrive at an opinion on the fairness of the financial statements.

The Audit Committee of the Board of Directors, composed solely of Directors from outside the company, meets periodically, separately and jointly, with the independent auditors and representatives of management to review the work of each. The functions of the Audit Committee include recommending the engagement of the independent auditors, reviewing the scope and results of the audit and reviewing management's evaluation of the system of internal controls.

W. Keith Kennedy, Jr.
President and Chief Executive Officer

Scott G. Buchanan
Vice President and Chief Financial Officer

Dividends and Stock Prices

1997 Quarters		1st	2nd	3rd	4th
Dividends declared per share (in cents)		12	12	12	12
Stock price (NYSE in dollars)	High	26 7/8	32 3/8	37 1/4	35 3/4
	Low	22 1/8	22 1/4	30 3/4	24 3/16

1996 Quarters		1st	2nd	3rd	4th
Dividends declared per share (in cents)		12	12	12	12
Stock price (NYSE in dollars)	High	44 5/8	36 1/4	28 3/4	28 1/4
	Low	34 1/4	27 1/8	17	17 3/4

CORPORATE DIRECTORY

Directors

Dr. Dean A. Watkins
Chairman

Dr. H. Richard Johnson
Vice Chairman

Dr. W. Keith Kennedy, Jr.
President of the Company

John J. Hartmann
Financial Consultant

Raymond F. O'Brien
Chairman Emeritus, Consolidated Freightways, Inc.

Dr. William R. Graham
Chairman and President, National Security Research, Inc.

Robert L. Prestel
Retired Deputy Director, National Security Agency

Gary M. Cusumano
President, Newhall Land and Farming Company

Subsidiaries

WJ Semiconductor Equipment Group, Inc.

WJ Telecommunications Group, Inc.

WJ Wireless Products Group, Inc.

Watkins-Johnson FSC

Watkins-Johnson International

Watkins-Johnson International Japan, K.K.

Watkins-Johnson International Korea, Ltd.

Watkins-Johnson International Singapore Pte., Ltd.

Watkins-Johnson International Taiwan

Watkins-Johnson Europe, Limited

Officers

Dr. Dean A. Watkins
Chairman of the Board

Dr. H. Richard Johnson
Vice Chairman of the Board

Dr. W. Keith Kennedy, Jr.
President and Chief Executive Officer

Scott G. Buchanan
Vice President and Chief Financial Officer

Dr. Patrick J. Brady
Vice President

Malcolm J. Caraballo
Vice President

Robert G. Hiller
Vice President

Darryl T. Quan
Controller

Claudia D. Kelly
Secretary

Groups

SEMICONDUCTOR EQUIPMENT GROUP

Dr. Patrick J. Brady
President

Allen S. Ibara
Vice President, Operations

Martin W. Mason
Vice President, Global Business Operations

Mark J. Danna
Vice President, Product Development and Engineering

James A. Bondur
Vice President and Chief Technical Officer

John F. Lunden
Vice President, Finance and Business Development

William R. Uhlemann
Vice President, Purchasing and Materials

TELECOMMUNICATIONS GROUP

Robert G. Hiller
President

Dr. Sharon A. Keillor
Vice President and Chief Operating Officer

Louis C. Passaro
Vice President, Manufacturing

Douglas P. Foster
Vice President, Government Sales and Customer Services

WIRELESS PRODUCTS GROUP

Malcolm J. Caraballo
President

Thomas R. Kritzer
Vice President, Business Operations

John G. Galli
Vice President, GaAs and Thin-Film Operations

Ralph E. Hoover
Vice President, Sales

SHAREOWNERS' INFORMATION

Annual Meeting

The annual meeting of shareholders is to be held at 10:00 a.m., April 18, 1998 at the corporate offices in Palo Alto.

Stock Exchanges

New York, Pacific, Boston and Philadelphia-Baltimore-Washington

Symbol: WJ

Transfer Agent

ChaseMellon Shareholder Services, L.L.C.
Overpeck Centre
85 Challenger Road
Ridgefield Park, NJ 07660

1-800-356-2017

TDD for the hearing impaired: 1-800-231-5469

Foreign shareholders: 212-613-7247

Website: www.chasemellon.com

A copy of the 1997 report to the Securities and Exchange Commission, Form 10-K, is available without charge to stockholders upon written request to the Manager, Corporate Planning and Communications, or by calling 650-813-2697. Watkins-Johnson Company news and financial reports are available on the Internet at: www.wj.com

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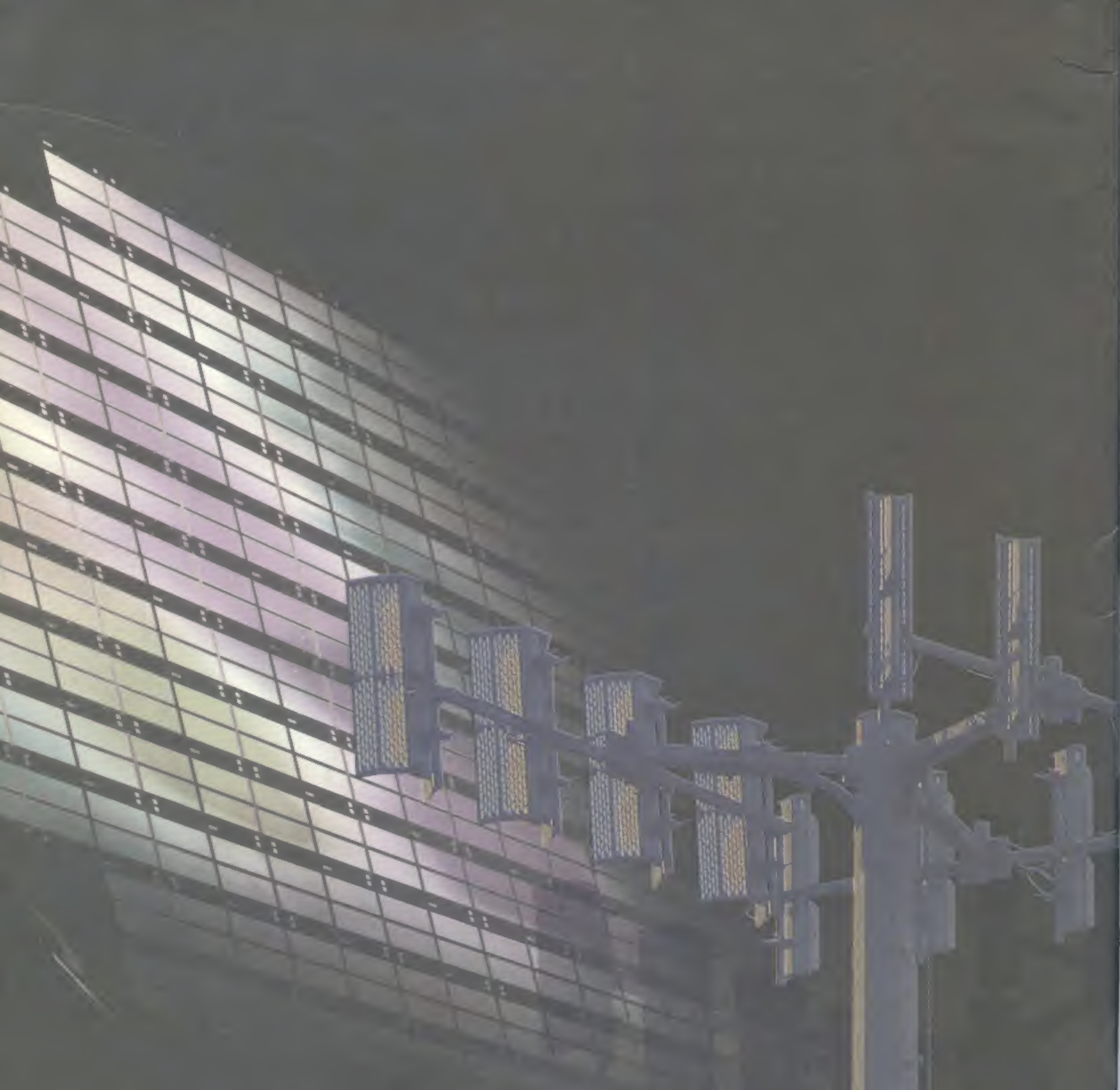
WATKINS-JOHNSON

Watkins-Johnson Company
Stanford Research Park, 3333 Hillview Avenue
Palo Alto, California 94304-1223



WATKINS-JOHNSON

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 Printed in U.S.A.

WATKINS-JOHNSON COMPANY

3333 HILLVIEW AVENUE
STANFORD RESEARCH PARK
PALO ALTO, CALIFORNIA 94304

DEAN A. WATKINS
CHAIRMAN OF THE BOARD

H. RICHARD JOHNSON
VICE CHAIRMAN

W. KEITH KENNEDY, JR.
PRESIDENT AND
CHIEF EXECUTIVE OFFICER

March 17, 1998

Dear Shareowner:

We, as well as all of the other officers and directors of Watkins-Johnson Company, cordially invite you to attend the Company's Annual Meeting of Shareowners, to be held at 10:00 o'clock in the morning on Saturday, April 18, 1998, at the main office of the Company, 3333 Hillview Avenue, Stanford Research Park, Palo Alto, California 94304.

In addition to conducting the business of the meeting, we will report to you on the progress of the Company and attempt to answer any questions you may have.

Please plan to come, but whether you can or cannot, please complete and return the enclosed proxy card—your participation is important.

Sincerely yours,

Dean Watkins

Dean A. Watkins

Dick Johnson

H. Richard Johnson

W Keith Kennedy

W. Keith Kennedy, Jr.

WATKINS-JOHNSON COMPANY

Notice of Annual Meeting of Shareowners
Saturday, April 18, 1998
10:00 a.m.

TO THE SHAREOWNERS:

The Annual Meeting of Shareowners of Watkins–Johnson Company will be held at the Company's main office, 3333 Hillview Avenue, Stanford Research Park, Palo Alto, California 94304 on Saturday, April 18, 1998, at 10:00 a.m. to take action upon the following matters:

1. The election of directors for the ensuing year.
2. The approval of the appointment of independent public accountants for 1998.
3. The transaction of such other business as may properly come before the meeting.

Only shareowners of record at the close of business on February 19, 1998, are entitled to notice of and to vote at this meeting and any adjournment or postponement thereof.

By Order of the Board of Directors

Claudia D. Kelly, *Secretary*

Palo Alto, California
March 17, 1998

WHETHER OR NOT YOU PLAN TO ATTEND THIS MEETING, PLEASE MARK, SIGN, DATE AND RETURN THE ENCLOSED PROXY AS PROMPTLY AS POSSIBLE IN THE ENCLOSED POSTAGE–PAID ENVELOPE.

WATKINS-JOHNSON COMPANY

PROXY STATEMENT

The accompanying proxy is solicited on behalf of the Board of Directors of Watkins-Johnson Company, a California corporation (the "Company"), for use at the Annual Meeting of Shareowners of the Company to be held at 10:00 a.m. on Saturday, April 18, 1998, and, at any adjournment of the annual meeting, to act upon the matters set forth in the accompanying notice. This Proxy Statement and the form of proxy, together with the Company's 1997 Annual Report, were first mailed to shareowners on or about March 17, 1998.

VOTING SECURITIES

Only shareowners of record at the close of business on February 19, 1998, are entitled to notice of and to vote at the annual meeting. On that date, the Company had outstanding 8,265,236 shares of common stock. Owners of common stock are entitled to one vote for each share held. In the election of directors, each shareowner has cumulative voting rights and is entitled to as many votes as equal the number of shares held by such shareowner multiplied by the number of directors to be elected, which votes may be cast for a single candidate or distributed among any or all of the candidates. However, no shareowner is entitled to cumulate votes unless the shareowner, or any other shareowner, has given notice at the meeting before the voting of such intention to cumulate votes.

SOLICITATION AND REVOCABILITY OF PROXIES

If the enclosed proxy card is properly signed and returned, the shares represented thereby will be voted at the annual meeting in accordance with the instructions specified thereon. If the proxy does not specify how the shares represented thereby are to be voted, the proxy will be voted as recommended by the Board of Directors. If the shares are held in trust under the Company's employee stock ownership plans, the shares represented will be voted by the Trustee, as directed by the participant, pursuant to the plans. Any shareowner signing a proxy in the form accompanying this proxy statement has the power to revoke it prior to or at the annual meeting. A proxy may be revoked by a written notice delivered to the Secretary of the Company stating that the proxy is revoked, by a subsequent proxy signed by the person who signed the earlier proxy, or by attendance at the annual meeting and voting in person.

The expense of soliciting proxies will be paid by the Company. Following the original mailing of the proxies and soliciting materials, employees of the Company may solicit proxies by mail, telephone, telegraph and personal interviews. The Company will request brokers, custodians, nominees and other record holders to forward copies of the proxies and soliciting materials to persons for whom they hold shares of the Company's common stock and to request authority for the exercise of proxies; in such cases, the Company will reimburse such holders for their reasonable expenses. Proxies will also be solicited on behalf of management by the firm of D. F. King & Co., Inc., whose fee ($8,500) and out-of-pocket expenses will be paid by the Company.

VOTING RESULTS AT LAST ANNUAL MEETING

There were 7,340,017 shares present and voting or withholding authority to vote at the Company's Annual Meeting of Shareowners held on April 5, 1997, for the purpose of electing directors and approval of the appointment of independent public accountants. A majority vote was required for each of these proposals. All nominees for director were elected by 98% or more of the votes cast and the appointment of Deloitte & Touche as the Company's independent public accountants was approved by 99.3% of the votes cast.

SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS & MANAGEMENT

The following table sets forth information as of December 31, 1997, with respect to the ownership of the Company's common stock by any person who is known to the Company to be the beneficial owner of more than 5% of the Company's common stock, by all directors, by the chief executive officer and four other highly compensated officers, and by all directors and officers of the Company as a group.

Beneficial Owner	Amount and Nature of Beneficial Ownership	Percent
Salomon Smith Barney Holdings, Inc. .... Travelers Group Inc. 388 Greenwich Street New York, NY 10013	525,436(1)	6.4
Mellon Bank Corporation .... One Mellon Bank Center Pittsburgh, PA 15258	780,841(2)	9.73
Central Securities Corporation .... 375 Park Avenue New York, NY 10152	425,000(3)	5.1
Directors and Officers		
Dean A. Watkins	259,020	3.1
H. Richard Johnson	36,259	*
W. Keith Kennedy, Jr.	317,872	3.8
John J. Hartmann	15,373	*
Raymond F. O'Brien	13,673	*
William R. Graham	22,203	*
Gary M. Cusumano	8,246	*
Robert L. Prestel	8,046	*
Malcolm J. Caraballo	81,448	*
Marc C. Elgaway	14,786	*
Scott G. Buchanan	55,517	*
Patrick J. Brady	8,758	*
All directors and officers as a group (15 persons)	868,376	10.2

* less than 1% of shares outstanding

(1) According to the Schedule 13 G filed by such shareowner, Smith Barney Holdings Inc. may be deemed to be the beneficial owner of the aggregate number of shares shown of the Company's common stock with shared power to vote, or direct the vote, over 525,436 shares and shared dispositive power over 525,436 shares.

(2) According to the Schedule 13G filed by such shareowner, Mellon Bank Corporation may be deemed to be the beneficial owner of the aggregate number of shares shown of the Company's common stock, with sole power to vote, or direct the vote, over 751,541 shares and sole dispositive power over 780,841 shares and shared dispositive power over 21,700 shares.

(3) According to the Schedule 13G filed by such shareowner, Central Bank Corporation may be deemed to be the beneficial owner of the aggregate number of shares shown of the Company's common stock, with sole power to vote, or direct the vote, over 425,000 shares and sole dispositive power over 425,000 shares.

The amounts shown include shares covered by options exercisable within 60 days of December 31, 1997, as follows: Dean A. Watkins, 6,000 shares; H. Richard Johnson, 6,000 shares; W. Keith Kennedy, 249,767 shares; John J. Hartmann, 14,773 shares; Raymond F. O'Brien, 11,673 shares; William R. Graham, 21,903 shares; Gary M. Cusumano, 7,746 shares; Robert L. Prestel, 7,746 shares; Malcolm J. Caraballo, 62,533

shares; Marc C. Elgaway, 13,333 shares; Scott G. Buchanan, 44,450 shares; Patrick J. Brady, 5,999 and all directors and officers as a group, 521,439 shares. Also included are 6,161, 8,115, 1,453, 4,767, and 2,759 shares for Messrs. Kennedy, Caraballo, Elgaway, Buchanan, and Brady respectively, which are allocated to their accounts, and 27,695 shares allocated to the accounts of all officers under the Company's employee stock ownership plans as of December 31, 1997, according to the plans' administrator.

ELECTION OF DIRECTORS
(ITEM 1 ON PROXY CARD)

At the annual meeting in 1998, there are eight nominees standing for election, each to hold office until his or her successor is elected, or until death, resignation or removal. All of the nominees are presently directors who were elected by the shareholders. Pursuant to the Company's Bylaws, the number of directors may not be less than seven nor more than eleven. The number currently fixed by resolution is eight. Shares represented by the accompanying proxy will be voted for the election of the nominees recommended by the Board of Directors, who are named in the following table, unless the proxy is marked in such a manner as to withhold authority so to vote. The affirmative vote of a majority of the common stock voting at the annual meeting is required to elect any director. The Company has no reason to believe that the nominees will not be available to serve their prescribed terms. However, if any nominee for any reason is unable to serve or for good cause will not serve, the proxy may be voted for such substitute nominee as the persons appointed in the proxy may in their discretion determine.

The following sets forth certain information concerning the nominees as of December 31, 1997, which is based on data furnished by them.

NOMINEES FOR ELECTION AS DIRECTORS

DEAN A. WATKINS

Chairman of the Board, Watkins-Johnson Company.

Director since 1957.

Dr. Watkins, 75, has been Chairman of the Board since 1967. He is a member of the Board of Overseers, Hoover Institution on War, Revolution and Peace (Chairman, 1971-73 and 1985-86). He is a Fellow of the Institute of Electrical and Electronics Engineers and of the American Association for the Advancement of Science, and a member of the National Academy of Engineering. He is a former member of the Board of Directors, California Chamber of Commerce (President, 1981); a former member of the Board of Regents, University of California (Chairman, 1972-74); a former Trustee of Stanford University, and a former member of the White House Science Council.

H. RICHARD JOHNSON

Vice Chairman of the Board, Watkins-Johnson Company.

Director since 1957.

Dr. Johnson, 71, was President and Chief Executive Officer of the Company from 1973 through 1987, and became Vice Chairman on December 31, 1987. He is a member of the National Academy of Engineering and a Fellow of the Institute of Electrical and Electronics Engineers. He is past President of the Stanford Area Council, Boy Scouts of America; and has served as a Director of the National Association of Manufacturers, the Santa Clara County Manufacturing Group and the Tech Museum of Innovation.

W. KEITH KENNEDY, JR.

President and Chief Executive Officer, Watkins-Johnson Company.

Director since 1987.

Dr. Kennedy, 54, has been President and Chief Executive Officer of the Company since December 31, 1987. Dr. Kennedy joined the Company in 1968, and was a Division Manager, Group Vice President and Vice President of Planning Coordination and Shareowner Relations prior to becoming President. He is a Director of CNF Transportation Inc., the Joint Venture Silicon Valley Network, and the Defense Space Consortium; a member of the Executive Board of The Center for Quality Management—West, and the Santa Clara Valley Manufacturing Group; and is a senior member of the Institute of Electrical and Electronics Engineers.

JOHN J. HARTMANN

Financial Consultant.

Director since 1966.

Mr. Hartmann, 79, is Chairman of both the Audit and Nominating Committees of the Board of Directors of the Company. He was a member of the Board of Directors of the Company from 1958 to 1961 and rejoined the Board in 1966. From 1967 to 1970 he was a general partner of J. Barth & Company, investment bankers, and prior to that was Chief Financial and Planning Officer of Kern County Land Company. Since 1970, Mr. Hartmann has had extensive experience as a director of and consultant to developing companies involving widely-diverse fields of activity. He has also been active as a board member and executive in civic organizations, primarily in the areas of youth activities and minority affairs.

RAYMOND F. O'BRIEN

Business Consultant

Director since 1986.

Mr. O'Brien, 75, is Chairman of the Compensation Committee of the Board of Directors of the Company. He retired as Chairman of the Board of CNF Transportation Co. in 1995 and was elected Chairman Emeritus. He is a Director of Consolidated Freightways Corp., and a former Director of Transamerica Corporation, Champion Road Machinery, Ltd., Union Bank, and the Mont La Salle Vineyards. He is also a former member of the Executive Committee of the American Trucking Association, a former Trustee of the ATA Foundation and former Chairman of the Western Highway Institute.

WILLIAM R. GRAHAM

Senior Vice President, The Defense Group, Inc., Falls Church, Virginia.

Director since 1989.

Dr. Graham, 60, is a member of the Audit and Compensation Committees of the Board of Directors of the Company. Since July 1997, he has served as Chairman of the Board and President of National Security Research, Inc., and as an officer of the non-profit National Institute for Public Policy. He formerly held the position of Senior Vice President, The Defense Group, Falls Church, Virginia. He is a Director of ElectroSource, Inc., was formerly a Director and President of C-COR Electronics, Inc. He left government service in 1989 after having been Science Advisor to the President and Director of the Office of Science and Technology Policy; Chairman of the Federal Coordinating Council on Science, Engineering and Technology; and Chairman of the Joint Telecommunications Resources Board from 1986 to 1989. He is former Deputy Administrator of the National Aeronautics and Space Administration, and former Chairman of the President's General Advisory Committee on Arms Control and Disarmament. In 1971 he was a founder of R&D Associates, a defense technology company, where he served until 1985.

GARY M. CUSUMANO

President, The Newhall Land and Farming Company, Valencia, California.

Director since 1994.

Mr. Cusumano, 54, is a member of the Compensation and Nominating Committees of the Board of Directors of the Company. He is a Director of the Newhall Land and Farming Company and the Zero Corporation. He is First Vice Chairman of the California Chamber of Commerce Board of Directors and Chairman of the Henry Mayo Newhall Memorial Hospital Board of Directors; and a member of the Stanford Sloan Alumni Advisory Board. He is a former Regent of the University of California (1984-1986), a former Chairman of the University of California Davis Foundation, and former President of the University of California Davis Alumni Association.

ROBERT L. PRESTEL

Business and Management Consultant.

Director since 1994.

Mr. Prestel, 62, is a member of the Audit and Nominating Committees of the Board of Directors of the Company. He retired as Deputy Director of the National Security Agency in February 1994 after serving the Agency since 1962. During his career he was Director of Education and Training from 1981 to 1983, and Deputy Director for Research and Engineering from 1985 to 1990. He is the recipient of the President's Distinguished Executive Award in 1988; the Department of Defense's Distinguished Civilian Service Medal in 1988; and the National Intelligence Distinguished Service Medal in 1991. In 1994 he was named as a "Reinvention Hero" by President Clinton for instilling quality management into the National Security Agency and for being a quality mentor throughout government service. He is a consultant to Alliant Techsystems, Inc. and a member of the Board of Trustees for the Institute of Defense Analysis; and formerly was a consultant for the Joint Advisory Committee of the Massachusetts Institute of Technology Lincoln Laboratories. He taught mathematics part-time at the University of Maryland.

FURTHER INFORMATION CONCERNING THE BOARD OF DIRECTORS

The Board of Directors met nine times during 1997. Standing committees of the Board include an Audit Committee, which met twice during 1997, a Compensation Committee, which met twice during 1997, and a Nominating Committee, which did not meet during 1997.

During the past year, the Audit Committee consisted of Directors Hartmann, Prestel and Graham. Among the Committee's functions are making recommendations to the Board of Directors regarding the continued engagement of independent auditors, reviewing with the independent auditors and Company financial management the plans for and results of the audit engagement, reviewing the adequacy of the Company's system of internal accounting controls, and reviewing and approving audit and nonaudit fees.

The Compensation Committee consisted of Directors O'Brien, Graham and Cusumano. The Committee's primary functions are to establish and administer the policies that govern the Company's executive compensation programs and to regularly evaluate these programs for their effectiveness in relation to the Company's financial performance.

The Nominating Committee consisted of Directors Hartmann, Cusumano and Prestel. The Committee's primary function is to direct the search for qualified candidates to fill Board vacancies that may occur and to recommend them to the full Board.

No incumbent director attended fewer than 75% of the aggregate of (1) the total number of meetings of the Board of Directors and (2) the total number of meetings held by all committees of the Board on which he served during 1997.

DIRECTOR COMPENSATION

Directors who are not employees of the Company each receive an annual fee of $21,600 and a fee of $300 for each Board or Committee meeting attended. In April 1994, Drs. Watkins and Johnson retired as employees of the Company and the Board approved execution of certain consulting agreements with them, as founders; the agreements specify an annual fee payable to Dr. Watkins in the amount of $265,000, and an annual fee of $125,000 payable to Dr. Johnson, in addition to the regular directors' fees.

Directors who are not employees also participate in the 1989 Stock Option Plan for Nonemployee Directors (the "1989 Director Plan"), amended and restated effective as of January 29, 1996, which was approved at the Company's 1996 Annual Shareowners' Meeting. It provides for each non-employee director to receive a stock option grant of 3,000 shares annually. In addition, the plan provides that new directors shall, upon election by the shareowners, receive an automatic, one-time grant of options to purchase 3,000 shares of the Company's stock. These options provide for the purchase of shares at not less than the fair market value of the stock on the grant date, fully vest six months after grant, and remain exercisable for a period of ten years from the date of grant. Vested options expire one year after the optionee's date of service ends. Options granted to directors before April 1996 begin to vest and become exercisable after two years from grant at a rate of 33 ⅓% per year. The expiration schedule for all grants is the same.

The aggregate number of shares which may be issued under the Plan is 350,000 shares of common stock; and as of December 31, 1997, there were 90,590 shares subject to outstanding options, and there were 196,909 shares available for future grants.

In 1995 a directors' retirement plan was authorized. This plan stipulates that each director who has completed at least five years of active service as a director shall, upon retirement from the Board, receive one-half of his/her quarterly fee as director for a period of years not to exceed one-half of the years of service as a director after April 8, 1995.

EXECUTIVE COMPENSATION

The following tables set forth all annual and long-term compensation, including stock option awards, paid or to be paid to the Company's chief executive officer, the four other most highly compensated individuals who were executive officers as of December 31, 1997 and other highly compensated officers during the fiscal year.

SUMMARY COMPENSATION TABLE

		Annual Compensation			Long Term Compensation		
Name and Principal Position	Year	Salary ($)(1)	Bonus ($)(2)	Other Annual Compensation ($)(3)	Restricted Stock Award(s) ($)(4)	Securities Underlying Options/ SARs (#)(4)	All Other Compensation ($)(5)
W. Keith Kennedy	1997	$463,726	$474,854	$18,347	-0-	25,000	$ 6,400
President & Chief	1996	459,290	36,657	11,165	-0-	-0-	39,211
Executive Officer	1995	440,000	87,431	5,255	-0-	110,000	87,685
Malcolm J. Caraballo	1997	198,165	182,845	7,608	-0-	2,500	6,400
Wireless Products	1996	184,562	7,028	4,628	-0-	-0-	10,574
Group President	1995	156,823	40,722	2,362	-0-	20,000	44,267
Marc C. Elgaway (6)	1997	226,844	143,916	-0-	-0-	40,000	6,400
Telecommunications	1996	208,640	68,646	-0-	-0-	30,000	70,817
Group President	1995	86,000	33,333	-0-	-0-	40,000	-0-
Scott G. Buchanan	1997	216,644	127,808	9,014	-0-	2,500	6,400
Vice President &	1996	208,370	12,827	5,668	-0-	-0-	17,268
Chief Financial Officer	1995	197,700	34,260	2,965	-0-	20,000	33,173
Dean A Watkins	1997	292,300	-0-	-0-	-0-	3,000	-0-
Chairman of the	1996	292,000	-0-	-0-	-0-	3,000	-0-
Board	1995	292,000	-0-	-0-	-0-	-0-	-0-
Patrick J. Brady	1997	227,400	-0-	-0-	-0-	40,000	6,400
Semiconductor Equipment	1996	175,460	17,581	-0-	-0-	30,000	12,895
Group President	1995	115,825	28,096	-0-	-0-	10,000	3,963

(1) Represents total base salary earned by the named officers, including amounts earned but deferred at the officer's election.

(2) For 1997, the method for calculating the bonus was based on a formula using revenue and return on controllable assets (ROCA) and individual performance objectives (IPO). The executive may elect to defer part or all of the bonus which will then appreciate or depreciate based on the ROCA of the individual's business unit for two years. After that time the bonus will appreciate based on the one year T-Bill rate. Also included is the bonus from the Employees' Cash Profit Sharing Bonus Plan, in which all employees of the Company participate based on a fixed percentage of pretax profits allocated over the salary base; however, in 1997 members of the corporate executive staff did not participate in the Employees' Cash Profit Sharing Plan. The amounts for 1996 and 1995 represent the vested portion of the Top Management Incentive Bonus Plan in the year awarded. For 1997 the bonus awards did not have an unvested component. Dr. Watkins does not participate in either of the aforementioned plans.

(3) Represents the interest accrued on salary electively deferred in accordance with the Top Management Deferred Compensation Plan. The aggregate amount of perquisites and other personal benefits, securities or property, given to each named officer valued on the basis of aggregate incremental cost to the Company, was less than either $50,000 or 10% of the total of annual sales and bonus for that officer during each of these years.

(4) Represents incentive stock option awards; although the Company's 1991 Stock Option and Incentive Plan permits grants of restricted stock and stock appreciation rights, no such grants have been made.

(5) Amounts shown for 1997 consist of the following: 401(k) matching contributions of $4,800 and ESOP contributions of $1,600 each to Messrs. Kennedy, Caraballo, Elgaway, Buchanan, and Brady. For 1996 and 1995 amounts shown represent Company matching contributions to the 401(k) portion of the Employees' Investment Plan, the Company Profit Sharing Plan, and Company contributions to the Employee Stock Ownership Plan and include the unvested, deferred portion of the Top Management Incentive Bonus Plan for all named officers. For 1996 and 1995, the method for calculating the bonus was based on a formula using certain measurement factors that include profit from operations, firm orders and return on controllable assets (ROCA). Fifty percent of the dollar value so awarded was deferred to appreciate or depreciate based on the ROCA for each participant's organization. This deferred bonus amount vests after two years from the award date and is then valued based on the ROCA measurement for the participant's organization at that time. All unvested bonus dollars or units are subject to a risk of forfeiture if the executive leaves the Company prior to the vesting dates. Dr. Watkins does not participate in the ESOP or the Top Management Incentive Bonus Plan.

(6) In December 1997, Mr. Elgaway resigned as vice-president of the Company.

1997 OPTION/SAR GRANTS TABLE

The following table sets forth incentive stock options granted to the named officers during 1997 under the Company's 1991 Stock Option and Incentive Plan. No stock appreciation rights (SARs) were granted in 1997.

OPTION/SAR GRANTS IN LAST FISCAL YEAR

Name	Individual Grants: Number of Securities Underlying Options/SARs Granted (#)(1)	% of Total Options/SARs Granted to Employees in Fiscal Year	Exercise or Base Price ($/sh)(2)	Expiration Date	Potential Realizable Value At Assumed Annual Rates Of Stock Price Appreciation: 5%($)	10%($)
W. Keith Kennedy	25,000	10.33%	$25.125	02/24/2007	$ 395,000	$ 1,001,000
Malcolm J. Caraballo	2,500	1.03	25.125	02/24/2007	39,000	100,000
Marc C. Elgaway	40,000	16.53	25.125	02/24/2007	632,000	1,602,000
Scott G. Buchanan	2,500	1.03	25.125	02/24/2007	39,000	100,000
Dean A. Watkins	3,000	1.24	26.875	04/28/2007	51,000	128,000
Patrick J. Brady	40,000	16.53	25.125	02/24/2007	632,000	1,602,000
All Optionees (4)	242,000	100.0			3,824,000	9,690,000
All Shareholders (5)	—	—	—	—	131,656,000	333,642,000
All Optionees' Gain as a percentage of All Shareholders' Gain					2.9%	2.9%

(1) For 1997 the Board of Directors determined that it was in the best interest of the Company to grant fewer stock options to those members of the executive staff who have, over the past several years received significant grants. Options granted in 1997 were incentive stock options up to the maximum allowed for each officer under Internal Revenue Code 422. The remaining awards were nonqualified stock options. Both incentive and nonqualified options are exercisable after 2 years from the grant date at a rate of 33⅓% per year, with full vesting occurring after the 4th anniversary date; however, all options become immediately exercisable in the event of a change in control of the Company. The options were granted for a term of 10 years, subject to earlier termination in certain events related to termination of employment.

(2) Exercise or base price is the fair market value of the underlying shares on the date of grant. Options may be exercised with cash or by delivery of already-owned shares of Watkins-Johnson Company common stock.

(3) The 5% and 10% assumed annual rate of stock price appreciation would result from per share prices of $25.125 and $26.875, respectively, for all named officers. Said assumed rates are not intended to represent a forecast of possible future appreciation of the Company's common stock or total shareholder return.

(4) For "All Optionees," the number of options granted is the total of all options granted to Company employees in fiscal year 1997. The weighted average exercise price of the grants was $26.41. For purposes of this table, the potential realizable value is based on the $25.125 per share price of the options granted to the named executive officer, as well as other officers, on February 24, 1997, and based on a ten-year option term (the term of all options granted in fiscal year 1997).

(5) For "All Shareholders," the potential realizable value is based on a ten-year appreciation of the 8,332,148 shares outstanding on February 24, 1997, and on the $25.125 per share price of the options granted to the named executive officer, and other officers, on that date.

1997 OPTION EXERCISES AND YEAR-END VALUE TABLE

The following table sets forth stock options exercised by any of the named executive officers during 1997, and the number and value of all unexercised options at year end. The value of "in-the-money" options refers to options having an exercise price which is less than the market price of Watkins-Johnson stock on December 31, 1997.

AGGREGATED OPTION/SAR EXERCISES IN LAST FISCAL YEAR AND FY-END OPTION/SAR VALUES

Name	Shares Acquired On Exercise(#)	Value Realized ($)(1)	Number of Securities Underlying Unexercised Options/SARs At FY-End (#) Exercisable/ Unexercisable	Value of Unexercised In-the-Money Options/SARs At FY-End ($)(2) Exercisable/ Unexercisable
W. Keith Kennedy	15,500	$151,620	179,766/ 131,668	$1,151,859/ 122,919
Malcolm J. Caraballo	5,400	70,338	50,865/ 20,835	453,409 17,503
Marc C. Elgaway	-0-	-0-	13,333/ 96,667	-0-/ 157,500
Scott G. Buchanan	12,333	280,148	29,449/ 24,168	131,770/ 27,919
Dean A. Watkins	-0-	-0-	6,000/ -0-	-0-/ -0-
Patrick J. Brady	-0-	-0-	5,332/ 77,668	-0- 157,500

(1) Based on the market price of the underlying shares at exercise date less the exercise price.

(2) Based on the market price of the Company's common stock at 12/31/97, which was $25.875 per share, less the exercise price.

Executive Employment Agreements

In 1997, the Company executed a three-year employment agreement with Dr. Kennedy which, in addition to providing for a base salary, contains the following terms: The agreement may be terminated for cause, in which case compensation ceases as of the date of notice. If the agreement is terminated without cause, compensation for the remainder of the term plus six months severance becomes immediately payable. The employee may not thereafter, for a period of two years, engage in competition with the Company. In the event of a change in control, as defined in the agreement, the employee may cancel the agreement for breach, upon 30 days written notice, and immediately collect the compensation due for the remainder of the term. The term of the agreement is three years, with the intention that it will be renewed after one year for three years in order to reflect his current salary and, in effect, extend the agreement term for another year. The agreement for Dr. Kennedy was concluded after his base salary was determined using the financial performance criteria and factors set forth under the compensation programs and policies described for the chief executive and other officers in the Compensation Committee report.

The Company maintains three-year severance agreements with other executives including Messrs. Caraballo, Buchanan, Watkins, and Brady which provide that if after a change in control, the employee is terminated other than for good cause, as defined in the agreement, or suffers a substantial alteration in the terms of employment and terminates his or her own employment because of such alteration, the

Company is obligated to pay the terminated employee 299.999% of the employee's yearly base salary compensation. The employee also has the right to terminate employment after 90 days and within 120 days of the change in control and receive from the Company one-half of the amount described above.

REPORT OF THE BOARD OF DIRECTORS' COMPENSATION COMMITTEE

Compensation Program and Policies

The Compensation Committee is responsible for establishing and administering the policies which govern base salaries, short- and long-term incentive compensation and stock ownership programs for the Chief Executive Officer and other executive officers. During the past year, the Committee was composed of three outside directors, Raymond F. O'Brien, Chairman, William R. Graham and Gary M. Cusumano.

Watkins-Johnson's compensation program is designed to attract and retain employees at all levels who will contribute to the long-range success of the Company. At the executive level, the program is broad enough to reward key managers for achieving both short- and long-term strategic Company goals, to link executive and shareholder interests through stock-based plans, and to provide compensation packages that recognize individual contributions as well as overall business results. Therefore, a significant portion of each executive's total compensation is intended to be variable and is contingent upon overall Company results, success of the executive's business unit, and accomplishment of individual performance goals.

Each year, the Committee conducts a careful review and evaluation of Watkins-Johnson's corporate performance, its executive compensation, and its incentive programs compared with two broad-based surveys of high-technology companies, as well as a smaller selection of geographically-related peer companies of similar size and organizational structure. These surveys are used to ensure that the Company's compensation practices are competitive in the markets in which it operates, and that its employees are fairly paid. The first two surveys present comparative information on all aspects of executive compensation used by high-technology companies nationwide, while data from the selection of peer companies presents compensation practices of companies that are closely aligned to Watkins-Johnson in terms of size, revenues and product lines. Analysis of all information combined enables the Company and the Committee to make well-informed decisions.

The three principal components of the Company's executive compensation program in 1997 were base salary, stock options, and a combined short- and long-term incentive award. Following are discussions of the Committee's philosophy and action in each area.

Base Salaries. Base salaries are designed primarily to attract and retain individuals, and to be competitive in our marketplace. Based on the information obtained from the salary surveys referenced above, base salary levels are deemed competitive if they are between the 50th and 75th percentiles of the marketplace for similar positions. The Company strives to pay its executives within this range, with salaries falling at low, high or medium-range depending on the following performance considerations. To arrive at base salary adjustments for 1997, the Committee considered the Company's financial performance in 1996, including the executive's business unit performance against the annual profit plan. Three factors—achieving planned profit, obtaining additional profitable orders, and developing new business for the long term—were considered. These factors were not assigned specific weights, but profit was considered most important, with orders secondary. Other factors considered in arriving at base salary adjustments related to the executive's individual performance and included overall managerial effectiveness, success in promoting teamwork and an ability to recognize and act upon the changing requirements of the workplace. Adjustments to executive base salaries in 1997 were also based on a qualitative analysis of each position's current responsibilities and expected contribution to the Company's fiscal health.

Stock Options. Under the 1991 Stock Option and Incentive Plan, stock options may be granted to executive officers and other key employees of the Company. The purpose of the awards is to align the executives' interests with those of shareowners. The size of stock option grants is measured by the same financial and individual performance criteria used to determine base salaries, and by the individual's position and responsibilities in the Company. In addition, consideration is given to the amount and term

of options already held. All stock options awarded to date under this plan have been granted with an exercise price equal to the fair market value of the Company's stock on the date of grant, with current grants beginning to vest after two years and becoming fully vested after four years. This is designed to encourage the creation of shareholder value over the long term, since no benefit is realized from the option grant unless the price of the Company's stock rises over a period of years.

The Company does not have a policy that requires the Committee to qualify stock options awarded to executive officers for deductibility under Section 162(m) of the Internal Revenue Code of 1986, as amended. However, consideration of the net cost to the Company is always a factor in making compensation decisions.

Short and Long Term Incentive Awards. The Top Management Incentive Bonus Plan is designed to reward executives based on achievement of certain predetermined goals, which include overall corporate results, business unit performance, and certain qualitative factors such as organizational and management development. The awards are made on a formula-based on performance against the financial objectives of revenue and return on controllable assets (ROCA), and a multiplier based on qualitative goals relating to strategic planning, development of staff, and positioning of the business unit for future growth. The performance criteria were individually tailored to each executive and his or her area of responsibility. In order to encourage attainment of the Company's long-term goals for continued growth and profitability, all or part of the award can be deferred by the executive to appreciate or depreciate based on the ROCA for each participant's organization. Thus, executives' interests are more closely aligned with those of our shareowners. During 1997, the Company divested a business unit. This divestiture proceeded smoothly and profitably. A bonus formula based on the sale price above the book value of the divested unit was developed which added to the incentive bonus of certain key executives.

Short- and Long-term Profit Sharing Plans. In order to encourage employees' interest and alignment with the Company's business objectives and performance goals, the Company has established a profit-sharing plan under which it shares a portion of its profits with all eligible employees, including executive officers. The Employees' Cash Profit Sharing Bonus Plan distributes about 6% of annual pretax profits to all employees who have been employed during the prior fiscal year. The approximately 6% profit amount is based on each business unit's annual pretax profit, thereby giving employees a good understanding of and reward for the achievements made within their own work areas. In 1997, members of the Corporate executive staff did not participate in this plan. Also, the Company contributes a matching contribution on employee 401(k) deferrals up to 3% of salary. There are no specific performance criteria relating to these plans.

Top Management Deferred Compensation Plan. In 1994, the Board approved implementation of a non-qualified deferred compensation plan for the Company's executives. Under the plan, participants may elect to defer up to 15% of their base salary which will earn the prime rate in effect at the beginning of each quarter. The election to defer must be made prior to the year during which the compensation is earned and cannot be revoked once the elected year begins. Funds so deferred will be distributed in a lump sum only upon the earlier of retirement, termination, death, disability, hardship, or change in executive status.

Compensation of the Chief Executive Officer

The same policies and programs described above were followed by the Committee in determining the 1997 compensation for Dr. Kennedy. As with the other executive officers, base salary is set, stock option awards are considered, and performance criteria are developed for the incentive bonus plan in February each year, based on the Company's financial performance and the CEO's individual contributions in the previous year.

The criteria for considering Dr. Kennedy's base salary was based on the Company's overall performance in 1996. Company performance factors included the percentage of profitability achieved against the annual profit plan, new orders booked, and the successful execution of the corporate strategic plan to prepare the Company for future growth and profitability. There were no specific weights assigned to these factors; but he continued his strong leadership of the Company during 1996. After careful study of chief

executive officer salaries from the survey information described under Compensation Programs and Policies, it was determined that Dr. Kennedy's base salary was within the range for companies of comparable size and market position. Therefore, the committee decided that there should be no increase Dr. Kennedy's base salary for 1997.

The criteria established for Dr. Kennedy's incentive bonus award are the same as those set for other executive officers. The award is made on a formula based on performance against the financial objectives of revenue and return on controllable assets (ROCA) with a multiplier based on qualitative goals relating to strategic planning, development of staff, and positioning of the company for future growth. The Committee met at the beginning of 1997 to approve the formula-based goals for Dr. Kennedy and other executive officers, and to establish his qualitative goals for the year. As chief executive officer, his financial measurements related to overall profitability and growth objectives for the whole Company, rather than individual business units, and his qualitative goals were based on development and execution of current and long-term strategies, development of management, and strengthening the total organization. The Committee then met just before year end 1997 to review the Company's financial results, and to evaluate his performance against his qualitative objectives. As with the other executive officers, the extent to which the formula factors are met, based on progressively difficult levels of achievement relating to financial returns and individual goals, determines the size of the award. During 1997, the Company divested a business unit. This divestiture proceeded smoothly and profitably. A bonus formula based on the sale price above the book value of the divested unit was developed which added to Dr. Kennedy's incentive bonus. Dr. Kennedy's corporate financial performance goals for 1997, together with achievement of his qualitative goals, were met at a level that resulted in an award to Dr. Kennedy under the incentive bonus plan equal to 103% of base salary.

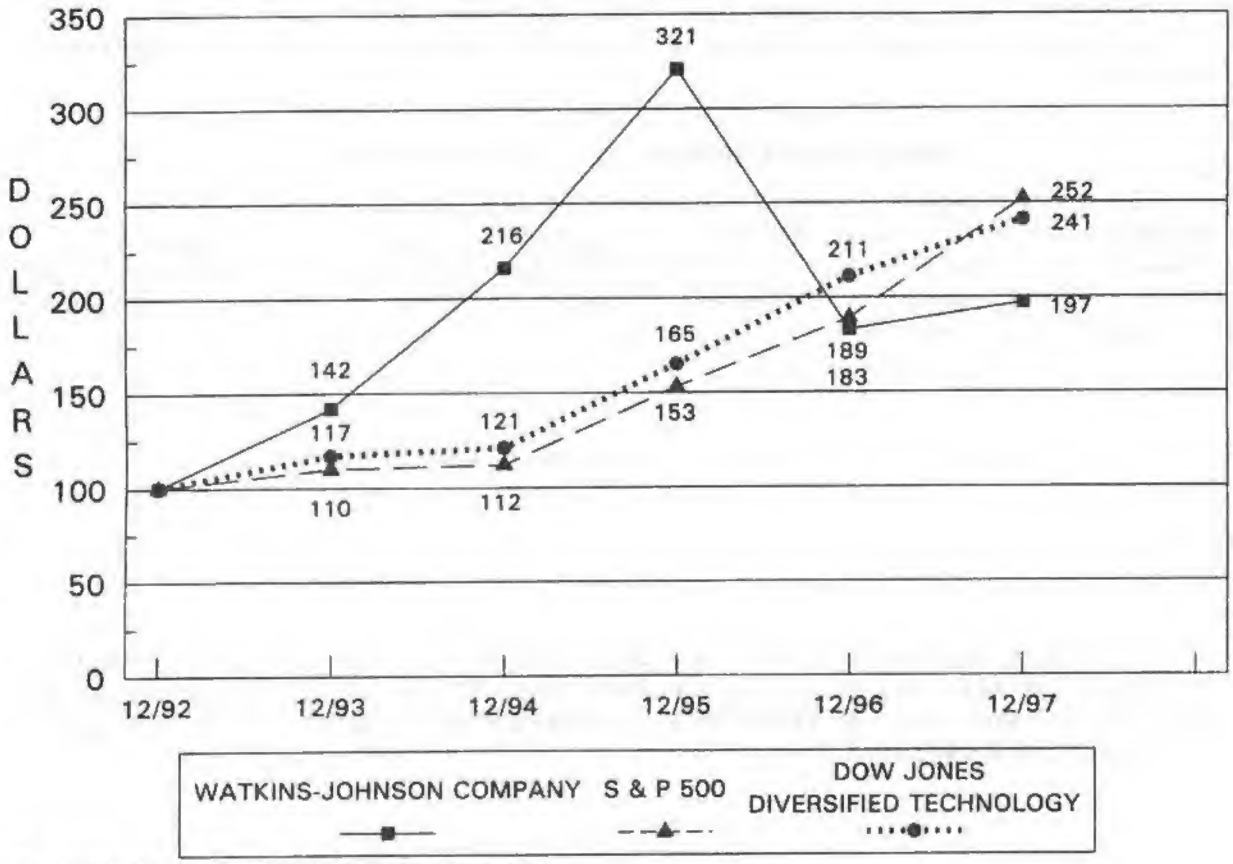
The Compensation Committee

Raymond F. O'Brien, *Chairman*
William R. Graham
Gary M. Cusumano

WATKINS-JOHNSON STOCK PERFORMANCE GRAPH

The following graph compares the cumulative total shareholder return (change in stock price plus reinvestment of dividends) of $100 invested on December 31, 1992, in the Company's common stock, the Standard & Poor's 500 Composite Index, and the Dow Jones Diversified Technology Index for a period of five years. The Standard & Poor's Composite Index was chosen as our broad equity market index because of its wide distribution and recognition by shareholders. The Dow Jones Diversified Technology Index was selected as having a representative industry peer group of companies. The Dow Jones index includes 11 companies with at least 2 high-technology business segments.

COMPARISON OF FIVE YEAR CUMULATIVE TOTAL RETURN*
AMONG WATKINS-JOHNSON COMPANY, THE S & P 500 INDEX AND THE DOW JONES DIVERSIFIED TECHNOLOGY INDEX



* $100 INVESTED ON 12/31/92 IN STOCK OR INDEX - INCLUDING REINVESTMENT OF DIVIDENDS. FISCAL YEAR ENDING DECEMBER 31.

APPOINTMENT OF INDEPENDENT PUBLIC ACCOUNTANTS (ITEM 2 ON PROXY CARD)

The Board of Directors has appointed the firm of Deloitte & Touche LLP as independent accountants of the Company for the current fiscal year, subject to the approval of shareowners. The Board of Directors expects that a representative of Deloitte & Touche LLP will be present at the annual meeting of shareowners, will be given an opportunity to make a statement at the meeting if desired, and will be available to respond to appropriate questions.

The vote required for approval of such appointment is a majority of the shares present in person or by proxy at the meeting.

The Board recommends that shareowners vote "FOR" the appointment.

OTHER MATTERS

As of the date of this Proxy Statement, the Board of Directors does not intend to bring any other business before the meeting and, so far as is known to the Board of Directors, no matters are to be brought before the annual meeting except as specified in the notice of the annual meeting. However, as to any other business that may properly come before the annual meeting, it is intended that proxies, in the form enclosed, will be voted in respect thereof, in accordance with the judgment of the persons voting such proxies.

SHAREOWNER PROPOSALS—1999 ANNUAL MEETING

Shareowners are entitled to present proposals for action at a forthcoming shareowners' meeting if they comply with the requirements of the proxy rules. Any proposals intended to be presented at the 1999 Annual Meeting of Shareowners of the Company must be received at the Company's offices on or before October 31, 1998, in order to be considered for inclusion in the Company's proxy statement and form of proxy relating to such meeting.

Claudia D. Kelly, *Secretary*

March 17, 1998
Palo Alto, California

YOU ARE CORDIALLY INVITED TO ATTEND THE ANNUAL MEETING IN PERSON. WHETHER OR NOT YOU PLAN TO ATTEND THE ANNUAL MEETING, YOU ARE REQUESTED TO SIGN AND RETURN THE ACCOMPANYING PROXY IN THE ENCLOSED POSTAGE-PAID ENVELOPE.